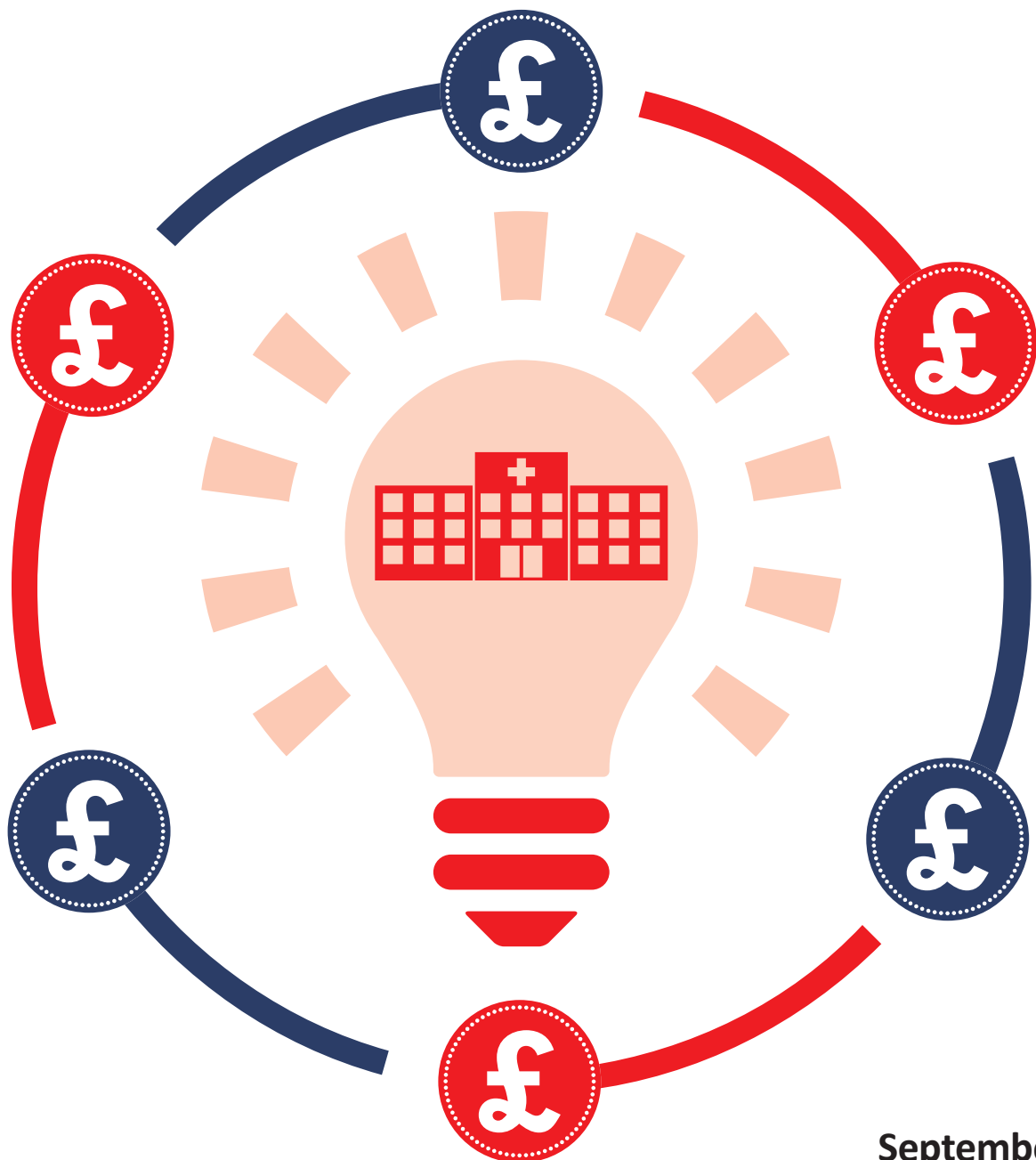


Dealing with the legacy of PFI – options for policymakers



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The Centre for Health and the Public Interest (CHPI) is an independent think tank committed to health and social care policies based on accountability and the public interest.

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The Centre seeks to frame the policy debate in a way that is evidence-based and open and accessible to citizens.

About the author

Vivek Kotecha is a Research Officer at the CHPI.

He previously worked as a manager in Monitor and NHS Improvement analysing and reporting on the operational and financial performance of the provider sector. Prior to that he worked as a management consultant at Deloitte for 4 years. Vivek holds a BSc Economics (Hons) from the LSE and is a chartered accountant. He has recently finished studying for a MSc Economics part-time at the University of London.

Contributing authors

Options 2 and 4 were written with Dr Mark Hellowell.

He is a Director of the Global Health Policy Unit at the University of Edinburgh.

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Email: info@chpi.org.uk

www.chpi.org.uk

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Executive Summary

1. We have identified in earlier reports and papers the extent to which the Private Finance Initiative (PFI) is having a negative impact on the delivery of services in the NHS. The National Audit Office (NAO) has also recently raised concerns about the impact of PFI on public services.
2. This report assesses 5 different options available to policy makers to address the negative aspects of existing (PFI) schemes. The options are costed and reviewed using data available for NHS PFI schemes, but the findings are broadly applicable to PFI schemes across the public sector.
3. Despite the restrictive nature of PFI contracts there are still clear actions that can be taken by policy makers to alleviate or tackle the most common objections to PFI schemes.
4. There is, however, no ideal solution to dealing with the problematic legacy of PFI schemes. Any option which is adopted by government will have significant costs to the taxpayer and so should only be adopted after full consideration of the feasibility of the proposal, the risks associated with it, and whether the benefits outweigh the costs.
5. By providing our best technical assessment of the 5 policy options we hope to advance and inform the current debate over how to tackle the legacy of PFI in the NHS and across the public sector.
6. We do not believe that any option is inherently superior to the others, each involves their own trade-offs and costs. Many of these options are not mutually exclusive and can be implemented concurrently or sequentially. They provide a toolkit from which policy makers can select the most appropriate option.
7. However, all will require a concerted effort from government and the local NHS to use all their available powers to address the burden of high costs, inflexible contracts, and excess profits. Rather than be passive in the face of these problems government needs to take an active approach, recognising that many of the companies involved are dependent on it for their profits and their income.
8. The 5 options assessed in this report are as follows:

Option 1: Improve the contract and performance management of PFI schemes

9. This option is the least radical of the 5 set out here. It examines the potential for the NHS to extract better value for money out of existing PFI contracts through the improved performance management and monitoring of PFI contractors. It looks at ways of pooling expertise across the NHS to ensure that financial penalties against PFI contractors are enforced resulting in lower costs and better value services to the NHS.
10. We estimate that this option could save the NHS £15m a year with far larger savings available through wider estates and facilities management strategies.

Option 2: Centralise part of the PFI interest payment to alleviate the financial burden on local NHS Trusts

11. This option looks at how the financial burden which affects those individual NHS trusts with high cost PFI schemes can be alleviated through pooling the cost across the wider NHS. It identifies that the high costs of PFI contributes significantly to the financial difficulties of NHS trusts with PFI schemes.
12. Under this option, those hospital trusts with a PFI scheme would still have to pay for their PFI hospitals. However, they would only be required to pay off the PFI debt at an interest rate which is the same as the cost of borrowing from the government. The Department of Health and Social Care (DH) would pay the additional costs of borrowing for PFI, over and above this rate.
13. We estimate that this would cost the DH around £400m (with inflation costs) and would involve some diversion of funds away from other centrally funded services – such as public health – but it would mean that the Trusts with PFI would have reduced their 2016/17 deficit by 30%.

Option 3: Use a windfall tax to deal with the excess profits made by PFI companies

14. This option is designed to tackle the excess profits made by shareholders in PFI schemes. We have estimated previously that £831 million has ‘leaked out’ of the NHS in the form of PFI profits between 2010 and 2015 and that a further £973m will leak out between 2016 and 2021. This amounts to 22% of the additional money granted to the NHS over this period.
15. This proposal would seek to claw back some of this excess profit by re-instating the 30% corporation tax rate on profits which applied when most PFI contracts were signed. PFI companies have received a significant windfall as a result of the reductions in corporation tax to 20%. The companies had not calculated their returns on the basis of receiving this windfall when the contracts were signed.
16. Such a tax could be applied retrospectively on profits already made – although this would be controversial – or on profits generated in the future. This is not the only way of taxing excess profits but it is set out here as a way of modelling the benefits and costs of such an approach. The use of taxes as a policy lever could encourage PFI companies to lower the costs of schemes to government in exchange for not having to pay the higher rate of tax on their profits.
17. We estimate that this would save the NHS £106m over 5 years but we also recognise that it could face legal challenges due to the way in which existing PFI contracts have been written. It may also have wider implications for government tax policy and the willingness of companies to invest in the UK in the future. Recouping a tax on profits would also be a challenge, particularly with regard to those PFI companies registered outside the UK.

Option 4: Terminate or buyout the PFI contracts

18. This option looks at the potential for the NHS to terminate or buyout the PFI contracts. It examines two examples where the NHS has already done this. In the first example, in Northumbria, the PFI contract was bought out using a loan from the local authority. In the second example in Tees Valley, the contract was terminated because of consistently poor performance by the PFI company.
19. The majority of government departments surveyed by the NAO would like to terminate and buyout their contracts and a survey by NHS Improvement in 2017 found that 16 NHS Trusts (15% of all the Trusts with a PFI scheme) were or had been in a position to terminate their contracts with PFI companies within the last 3 years.

- 20. We identify that there are substantial costs associated with buying out PFI contracts, to the extent that this option is unlikely to be affordable to most NHS Trusts and the Department of Health and Social Care. We also identify that terminating the contract on the basis of poor performance will also have high costs to the NHS due to the way in which the PFI contracts were written. We are unable to fully quantify the cost at this stage.
- 21. This option is worth further exploration by policy makers as it appears that there are numerous opportunities for NHS Trusts to extricate themselves from PFI contracts on the basis of default by the PFI operator.

Option 5 – Nationalise the PFI operating company (the SPV)

- 22. This is the most radical option for dealing with the existing burdens of PFI. It involves Parliament passing an Act to expropriate the shares of those investors who own the Special Purpose Vehicles (SPVs) established to manage PFI contracts. This Act of Parliament would provide compensation to the shareholders on the basis of the existing book value of the SPVs, which would mean that the government would have to pay £2.6 billion to nationalise all PFI companies across the NHS and the public sector.
- 23. This option would not nationalise the debt, which amounts to over 90% of the total financing of PFI schemes, and so the public sector would still be required to repay this at their existing interest rates. However, by transferring the shares of the SPV into public ownership the government would then be in a strong position to re-finance these loans at a rate which is similar to the current cost of government borrowing.
- 24. In addition, the service contracts between the SPVs and their contractors would be changed so that the contracts are instead directly between the relevant public authority and the contractors. Under this approach, the public authority would also save money in the form of the profits made by the SPV when it subcontracts out maintenance work.
- 25. In total it is estimated that this proposal would save around £1.4bn a year post-nationalisation with greater savings from reduced interest charges on loans.
- 26. Any government which chooses to take forward this radical and ambitious proposal is likely to require a large majority in Parliament to pass such an Act of Parliament. It is also likely to face legal challenges from PFI investors which could take the form of a challenge under international trade law or under Human Rights legislation. In particular the level of compensation to be paid to PFI companies under this proposal is likely to be considered too low by shareholders as it is based on the 'book value' of the companies rather than the 'market value' which has been used in other episodes of nationalisation.

27. We also identify the fact that there is no guarantee that the re-financing of the PFI debt would occur as a result of this proposal and that in order to reduce the high cost of PFI debt a further Act of Parliament might be required to nationalise these loans.

Helping policy makers to decide which options meet their objectives

28. We recognise that making a decision about which option to use is likely to be influenced by the particular concerns of individual policy makers. For example some policy makers may be comfortable with the outsourcing of public services but might object to the high cost of PFI. In order to provide a further indication of which option may be most attractive Table 1 sets out the extent to which each solution seeks to address 3 common objections:

Table 1 – Policy options and the objections that they seek to address

Option proposed	Objection(s) addressed		
	Financial burden of PFI	Poor value for money/excess profit making	Outsourcing of services
Improve contract and performance management		✓	
Centralise part of the PFI interest payment	✓		
Tackle/cap excess profit making		✓	
Terminate the PFI contract	✓		✓
Nationalise the PFI operating company (the SPV)	✓	✓	✓

Part 1: Introductory Section

Introduction

1. This report has been produced in response to ongoing concerns about the impact of the Private Finance Initiative (PFI) on the financial sustainability of public services and the effects of contracting out the delivery of public services to private for-profit companies, following the recent collapse of the PFI construction and services provider Carillion.
2. The nature of these concerns has led many to consider different ways of addressing the negative aspects of PFI, and the purpose of this report is to provide a detailed assessment of 5 different options available to policy makers. Our primary focus is the NHS, which has the second largest number of PFI schemes; however the options assessment set out here has a wider applicability across the public sector.

The nature and cause of the problem

3. There are currently over 700 PFI schemes in the UK, with a total capital value of approximately £60bn.ⁱ Once the total annual charges (known as ‘unitary payments’) for these projects have been paid by public authorities, over £306bn of taxpayer funds will have been spent.ⁱⁱ Of these schemes, 127 are PFI schemes for hospitals and social care with a capital value of £13bn, incurring total annual payments of £82bn.¹
4. The responsibility for making the payments due under PFI contracts does not always rest with central government but in many instances is devolved to local public bodies such as local authorities and NHS trusts. This means that payments for NHS PFI contracts, for example, come out of the budgets available to the NHS to provide healthcare services.
5. In this way, PFI is an issue which is relevant to the delivery of all forms of public services and has the ability to impact on both the availability and quality of the services which are provided.
6. PFI deals were negotiated with the private sector with the specific intention of raising finance for capital infrastructure projects through financial institutions (primarily banks and investment funds), whilst ensuring that the cost of these projects did not appear as borrowing in the government’s preferred debt figures (Public Sector Net Debt and Public Sector Net Borrowing).

i The capital value is the total funding requirement for a project as at the date of financial close of individual contracts. It reflects the aggregate debt and equity finance in a project, plus any capital contributions made by the public sector.

ii This figure includes payment for the services provided, repaying the cost of construction of infrastructure, the interest on the loans taken out, and profits for the PFI investors. It is nominal and undiscounted.

7. Some would argue allowed that this drive to move public borrowing “off balance sheet” allowed different governments to invest in hospitals, schools, and other infrastructure projects to a degree that would not have otherwise been possible under their self-imposed borrowing limits.
8. However, accessing private finance in this way required the government to strike deals with the private sector which over the longer term have been shown to be in many regards sub-optimal, and which have stored up a series of problems for policy makers to contend with.

The legacy of PFI for policy makers

9. These problems, all of which result from the bargain which government struck with the private sector to finance public infrastructure projects whilst ensuring that the borrowing is “off balance sheet”, can be summarised as follows:
 - The payment of a higher price for public infrastructure (such as schools and hospitals) than would have been the case had the government borrowed the money itself;
 - a commitment imposed on future governments and public authorities to make payments to private providers at this higher rate over a 25-35 year period irrespective of whether the public authority can afford these payments;
 - the existence of long and detailed contracts for the maintenance of public infrastructure which are costly and difficult for public authorities to monitor and enforce; and
 - a commitment to continue to make payments over a 25-35 year period under the terms of these contracts even in the most extreme circumstances, such as the private contractor going bust or the school or hospital no longer being needed.
10. We consider that these are the key issues which policy makers must address going forwards in order to deal with the legacy of PFI. We set out in more detail below the nature of these problems.

The high costs of PFI

11. PFI projects are funded in two ways: using loans from banks (and other financial institutions) and using equity from shareholders who invest in the deals. A PFI operating company, known as a Special Purpose Vehicle (SPV), is set up to receive these funds and arrange construction of the asset along with contracted maintenance services for the lifetime of the contract. PFI schemes have unnecessarily high costs associated with both the costs of loans and shareholder investments.

Returns to lenders

12. The majority of the financing (usually 90%) for PFI schemes is borrowed from banks and other financial institutions. The interest rates attached to these loans are higher than if the government borrowed directly because it can almost always borrow more cheaply than the private sector. In addition, the interest rates on the private debt raised under PFI schemes are high compared to the current interest rates charged for private sector borrowing, because most deals were signed before the 2008 financial crisis and the subsequent fall in interest rates.
13. In 2013/14 it was estimated that the implied interest rates of private finance were 7.2-7.4% compared to government's borrowing rate of 3.1-3.4%.² This higher cost of borrowing translates into more expensive hospitals. For example, the Treasury Committee estimated that the cost of a privately financed hospital was 70% higher than a public sector financed build.³
14. The high rates of interest also mean that the annual payments made each year to PFI companies by local authorities and NHS trusts are higher than they would have been if the government had borrowed directly.

Returns to equity holders

15. In addition, unlike when public infrastructure projects are financed through public borrowing, PFI deals also involve payments to the shareholders of the PFI operating companies, the SPVs. Research by CHPI has shown that the profits made by PFI SPVs in the health and education sector are substantial, in the region of £1.1 billion over 5-6 year periods.

Table A1: Interest payments and pre-tax profits made by PFI SPVs in the health and education sectors.

Sector	Number of schemes covered	Period covered	Interest payments made	Pre-tax profit	Interest payments as multiple of profit
Health	107	2010 - 2015	£4,354m	£831m	5.2x
Education	139	2010 - 2016	£2,321m	£329m	7.1x

Sources: 'P.F.I Profiting from Infirmaries', August 2017, CHPI; 'Counting the cost of school PFI schemes', February 2018, CHPI.

16. Whether this level of profits represent a 'fair' rate of return for the risks taken on by the shareholders of the PFI companies is hard to calculate, given the lack of public information available. However, research on a sample of 77 PFI projects in the health sector (between 1997 and 2011) has found that they have made excessive returns given their cost of funding.⁴ An earlier study by PricewaterhouseCoopers found that the post-tax rates of return for shareholders were on average 2.4% greater than the expected return for an investor (given the cost of funding and risks involved).⁵

17. For most PFI schemes the greatest risk for the shareholders is during construction. Payments aren't made by the public body until construction is complete and cost overruns impact the shareholders' returns. Once construction is finished the remaining risks are the risk of possible deductions from the contracted annual payment for not completing maintenance or facilities work to the contractual standards. At this point many of the original PFI investors sell their shares in the SPV. These sales have typically generated annual returns of 15-30% for investors – a sign that new buyers think that the schemes are still profitable even with lower returns.⁶ There is also evidence that little or no tax is being paid by the largest investors in PFI projects.⁷

Potential benefits of PFI

18. Successive governments have argued that the additional borrowing costs for PFI projects and the profits made by the SPVs are justified. On this view, the private sector is better able to deliver the construction of schools and hospitals on time and it is more efficient in managing the facilities (for example, maintaining and cleaning the building) than the public sector.
19. Regarding the timeliness of construction, PFI schemes have been completed within budget more often than non-PFI schemes.⁸ However, to control for this some PFI projects charged higher construction prices to cover cost overruns, so this certainty didn't necessarily lower costs relative to non-PFI construction projects.³ The NAO notes that these benefits could have been obtained outside of PFI by using fixed price contracts, or by limiting the PFI contract to the construction period only.
20. It was expected that given the long-term nature of the contracts, the PFI operators would have an incentive to reduce running costs, which should generate operational efficiency. However work by the NAO has found no evidence of operational efficiency in PFI hospitals, and more recently data from the NHS London Procurement Partnership found that in London the costs of services in hospitals are higher under PFI contracts.^{9 10}
21. An increased or similar cost of services may imply a better quality of service and/or working conditions. However, it can be hard to monitor quality and there is evidence that outsourced (including non-PFI) hospital cleaning services are associated with a higher incidence of MRSA.¹¹
22. Irrespective of the value for money, or lack of value, of PFI projects, public authorities such as NHS trusts are required to pay these higher borrowing costs and profits for PFI companies out of their budgets, and so the high costs of PFI can create financial sustainability issues for these authorities.

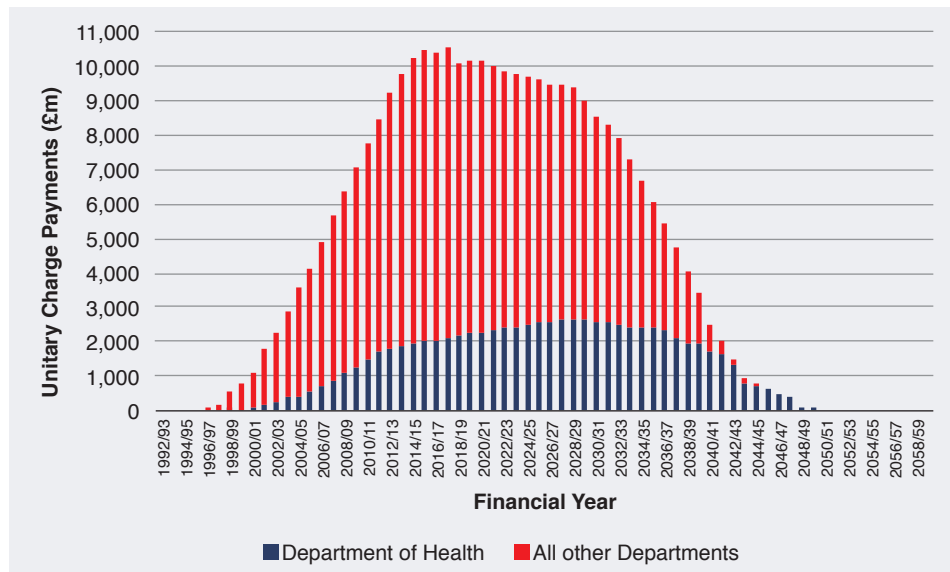
The affordability of PFI in the context of austerity

23. In order for the PFI SPVs to be able to secure financing for their infrastructure projects from banks and shareholders, they sought a long-term commitment from government to make regular payments to them, often over a 25-35 year period. PFI contracts were written in such a way as to ensure that the government would continue to pay off any loans used to build the hospital or school, except in extreme circumstances. It was necessary to make these guarantees in order to reduce the risks to lenders and so keep the cost of borrowing as low as possible.
24. This guarantee from government to continue to make payments to lenders is at the heart of the Treasury's standard contract – in particular the Lenders Agreement signed between the public authority and the banks which provide the financing – and it is also written into primary legislation in the form of Acts of Parliament.ⁱⁱⁱ One Act (1996) sets out the requirement for the government and the taxpayer to continue to make payments to private companies even if a NHS Trust is dissolved.
25. At the central government level, this commitment to make payments over a 25-35 year period has an impact on how government departments manage their budgets. Unlike standard public capital investments, private finance investments are not paid for centrally by the Treasury but instead come out of individual departments' budgets. PFI contracts entail a financial commitment for 25-35 years whilst departmental budgets are only set for 5 years at a time. This mismatch makes it hard to budget for PFI payments over the long term.
26. For many departments, 2010/11 – 2017/18 represent their peak PFI repayment years, with most of the schemes operational. For the Department of Health and Social Care the peak repayment year is later, in 2029/30.
27. During these peak years PFI repayments have been, in part, rising with RPI inflation (as per the contracts), whilst department budgets have not kept up due to austerity measures. This toxic mix of rising PFI repayments, made worse by rising inflation, and departmental budgets that are not rising at the same pace, is currently limiting departments' financial flexibility. It also means that payments to PFI companies are given precedence over other items of expenditure.

ⁱⁱⁱ National Health Service (Private Finance) Act 1997 and the National Health Service (Residual Liabilities) Act 1996. In addition, for NHS Trusts which converted into Foundation Trusts, a Deed of Safeguard was signed by the Secretary of State for Health.

Figure A1: PFI actual and forecast unitary payments

Payments peak in 2017/18 across all departments and in 2029/30 for the Department of Health and Social Care



Source: HM Treasury PFI 2016 summary data

28. There are £199bn of annual PFI payments still to be made by public bodies to PFI companies, of which £63bn are due to be paid by NHS hospital trusts and other public bodies for health PFI schemes. For many departments, as the size of annual unitary payments falls from 2018/19 onwards, they will get some relief, but the cost will still be the other investments stalled and services cut to pay for their PFI obligations in the previous years.

The impact of PFI locally

29. Even though central government has required local authorities and NHS trusts to procure new schools and hospitals using PFI, it is the local authority and the local NHS trust which are legally required to make the payments each year. Whilst central government does provide some additional financial assistance to local NHS trusts and local authorities for PFI, in the main these payments have to be made out of the budgets which they have been allocated for healthcare, social care, education, transport, and housing.
30. At a local level the consequences of this on public services at a time of severe limits to funding growth has been significant. Irrespective of the financial position of a local authority or school, the payments to PFI companies must take precedence over all discretionary spend.
31. For example, Northamptonshire County Council, which has a predicted budget shortfall of £60-70m for this financial year, has been forced to cut back its services to the statutory minimum but is still legally required to make payments to PFI companies of around £28m a year until 2038.^{1 12}

32. The commitment to make payments to PFI companies, including large interest payments on the PFI debt, is something which most local authorities in England are now facing, despite the fact that they are struggling to fund essential services such as social care. Many are having to spend more on the services that they provide than the income they receive. At the same time, many will in future face cash flow difficulties with the balance between short term liabilities (upcoming payments out) and short term assets (cash readily available) falling, and in some cases being negative (i.e. leaving them with negative working capital). Persistent negative working capital suggests that they will have to rely on borrowing to meet their future costs, as their income is insufficient. As PFI payments are made in cash this also raises questions over how they will be funded in future.

Table A2: The over/under spend providing services, working capital position, and the PFI payments due over the next 2-5 years for 8 local authorities at the end of 2016/17.

Local Authority	Surplus/ (Deficit) on provision of services in 2016/17	Positive/ (Negative) Working Capital 2016/17 (current assets less current liabilities)	Total PFI payments due over next 2-5 years	Amount of Total that is payment of interest
Birmingham City Council ^{iv}	£(128m)	£(701m)	£383m	£126m
Doncaster Metropolitan Borough Council ⁴	£131m	£20m	£65m	£14m
Ealing Council	£(14m)	£76m	£110m	£38m
Hull City Council	£(49m)	£4m	£71m	£31m
Norfolk County Council	£(75m)	£129m	£57m	£21m
Plymouth City Council	£(37m)	£(166m)	£53m	£23m
Surrey County Council	£(152m)	£(144m)	£387m	£51m
City of Wolverhampton council ⁴	£27m	£(114m)	£89m	£40.5m

Source: Local Authority Statement of Accounts 2016/17

NB: Part of the PFI total payment cost is reimbursed from central government using PFI grants.

33. The Department of Health and Social Care (DH) has argued that the overall impact of PFI on the provision of NHS services, and by implication on the financial sustainability of the NHS, is negligible.¹³ At a global level NHS trusts paid £1.9billion in PFI unitary payments in 2016/17 which is 1.6% of DH's total revenue budget.^{v 14}

iv Does not included consolidated results for group companies.

v Author's calculations based on trusts' accounts. Revenue budget refers to Revenue Departmental Expenditure Limit (RDEL).

34. At an individual Trust level these payments average 4.2% of their total income. Within this average there is a wide variation, with a median value of 2.8% and the average being pulled up by 12 trusts with unitary payments representing 10% or more of their total income.^{vi} By this metric (unitary payments as a share of total income) the burden of PFI has been falling, as some hospital incomes have risen faster than unitary payments.
35. However, this metric is misleading if it is the only one considered. Whilst recognising that the majority of NHS trusts in England are struggling financially, those NHS trusts with a PFI scheme have a particular difficulty with their liquidity, i.e. having the actual cash resources available to deliver healthcare within a hospital. This is because PFI payments represent a growing annual cash payment at a time when hospital trusts are already struggling to find enough cash to pay for their staff, estates, and equipment.^{vii}
36. The growing cash shortages mean that many NHS trusts have been forced to borrow money from the Department of Health and Social Care at an interest rate of 1.5-3.5% in order to keep delivering healthcare services,¹⁵ whilst those in special measures can end up paying higher interest rates of up to 6%.¹⁶ By 2017/18 DH has lent out £7.3bn of these emergency loans ('interim revenue support'), a substantial increase from £0.8bn in 2014/15.¹⁷
37. For short-term borrowing this is acceptable, but with persistent liquidity troubles some trusts are becoming reliant on loans from the Department of Health and Social Care, which casts doubt over their long-term financial sustainability.
38. This gives an indication of the short-term impact of PFI on a hospital's financial sustainability, which in turn limits their ability to invest cash in other buildings or equipment.

The problems with monitoring and enforcing long term PFI contracts

39. In addition to constructing an asset, PFI contracts usually include facilities management and maintenance contracts that last for the duration of the PFI agreement. For example, in hospitals these additional services often include portering, cleaning, and the preparation of meals, as well as the maintenance of the PFI building. The terms governing these services are extremely detailed and require monitoring by the public body throughout the entire PFI contract term of 25-35 years. This is a very long period of time to outsource a service, given that the Treasury does not normally allow departments to enter contracts which last more than 7 years.¹⁰

vi As with local authorities, there is PFI support income available for some trusts. In 2016/17 £21m of PFI support income was provided to six NHS Foundation Trusts.

vii For a more detailed analysis of the impact of PFI on financial sustainability see Kotecha, forthcoming.

- 40. In addition to the complex nature of these contracts, the public sector does not have the necessary expertise to fully monitor and enforce them, as this is an additional expense which few public bodies can currently afford. Instead the NAO has found that NHS Trusts use private consultants who are paid a proportion of the savings ‘identified’, even though these savings are very difficult to deliver in practice.¹⁰
- 41. This lack of capacity to enforce and monitor contracts and to attempt to make savings through changes to the contract is reflected in a recent survey by NHS Improvement. This survey found that the number of staff dedicated to managing or monitoring the PFI contract varies across NHS hospital trusts from 0 to 10 WTE (whole time equivalents), which is linked to the size of the contract.
- 42. Of 81 trusts with PFI schemes that responded to a survey only 40 had contract and site management teams co-located, which helps with contract monitoring and enforcement. Seventeen trusts reported that they did not have access to key PFI performance information, which makes the independent monitoring of any underperformance against the contract hard to deliver.¹⁸
- 43. The NAO also found that there is no centralised coordination of efforts to make savings – NHS trusts engage with different private consultancy firms for savings advice. This may reduce the chance that lessons can be learned and shared across the public sector.
- 44. In addition, when the public sector wants to amend the contract, to either deliver different services or to extract efficiencies, the contract structure means that changes can be expensive, with lenders and investors charging administrative and management fees. Even simple requests can become expensive, with one local authority PFI school finding that the cost of £60,000 of capital works increased to £100,000 once the PFI company’s fees were included.¹⁰ Ultimately, it is up to the PFI operating company to agree to changes in the scope of services, and they have no incentive to do so unless it improves their profits.

The requirement to keep making PFI payments, except in extreme circumstances.

- 45. The nature of the legal guarantees given by the government to make PFI deals financially attractive to investors has meant that it is extremely difficult to exit these deals without paying a large amount of compensation, even in extreme circumstances. In spite of these disincentives, 9 out of 10 Government departments surveyed by the NAO are interested in buying out their PFI deals.¹⁰

46. The standard contract for PFI schemes provides a series of disincentives for public bodies to exit their contractual arrangements through termination. As the NAO illustrates, the standard contract requires the following payments in the event that a contract is voluntarily terminated by the public sector:¹⁰

To the lenders

- the amount of debt outstanding; plus
- the cost of terminating hedging arrangements (such as interest swaps) in the case of bank financed deals or in the case of bond financed deals a premium to allow investors to get a similar return from investing in another bond.

To the equity investors

47. The level of compensation to be paid to equity investors (including equity provided in the form of shareholder loans) will depend on the calculation chosen by the investors when the deal was initially agreed. This will be one of the following:
- the return expected at the start of the contract compared to actual return so far. If the investors have already achieved the return there will be no compensation required; or
 - the expected return for the remaining part of the contract; or
 - the market value of the equity and shareholder loans – assessed as if the contract was to continue to run.
48. The NAO also details how local authorities and NHS trusts are required to continue making payments under PFI contracts for buildings and services that they no longer require. The example used by the NAO was Liverpool City Council, which is paying around £4 million each year for a school which is now empty. Between 2017-18 and the contract end in ten years, the council will pay an estimated £47 million, which includes interest, debt and facilities management payments, if no changes are made to the contract.¹⁰
49. Another scenario where the public sector can terminate a PFI contract is when it is manifestly clear that the performance by the PFI provider is so poor that there can be no question that it has failed to meet its contractual requirements. This has happened in the recent case involving Tees, Esk & Wear Valleys NHS Foundation Trust, which was recently given the right to terminate its PFI contract due to a persistent series of breaches by the PFI SPV.¹⁹
50. Even in this scenario there is a significant disincentive to pursue termination, due to the fact that replacing the PFI operating company requires paying them a significant amount of compensation for their lost future income. Even after the liquidation of Carillion the NAO found that some public sector bodies are paying a 20% premium for post-liquidation services and some customers will incur costs in replacing Carillion as a contractor.²⁰

51. This may explain why a number of NHS Trusts which have had the opportunity to terminate their PFI contracts have chosen not to do so.

Dealing with the legacy of PFI: the need for evidence based options for policy makers.

52. The legacy of the policy decisions taken by governments in the 1990s and 2000s on the Private Finance Initiative poses highly complex and challenging problems for policy makers. There have been various ideas put forward since 2010 to deal with this legacy.
53. One set of solutions has focused on reforming the approach to the private financing of public infrastructure projects so that some of the same difficulties are not encountered in the future. This has led to the creation of the Private Finance 2 (PF2) approach whereby the finance arrangements for privately financed public infrastructure projects rely less on banks and more on equity from shareholders, and also permit the government to hold equity shares. In addition, PF2 contracts do not require public bodies to sign up to long term contracts for the provision of cleaning and maintenance services.
54. Others have put forward solutions designed to tackle the problems associated with existing PFI schemes. These include the introduction of a windfall tax on excess profits, a voluntary rebate paid by PFI contractors, and the nationalisation of PFI companies.^{21 22 23}
55. We are firmly of the view that it is possible for government to act with regard to existing PFI schemes. Whilst the nature of the policy was intended to tie the government's hand in order to provide certainty to investors that their returns would be secure, it should not be forgotten that the profitability of some private sector providers engaged in PFI is dependent on the taxpayer who provides them with the vast majority of their income.
56. Public bodies and government departments are also parties to contracts with private providers and lenders, which also gives them contractual rights which in many cases have not been exercised.
57. We are also clear that there is no ideal solution to dealing with the legacy of PFI. Any option which is adopted by government will have significant costs to the taxpayer and so should only be adopted after full consideration of the feasibility of the proposal, the risks associated with it, and whether the benefits outweigh the costs.
58. Whilst there are differing views across the political spectrum about how to deal with the legacy of PFI, our intention in publishing this report is to pull together our best technical assessment of the 5 policy options listed below. We acknowledge that there has been and will continue to be a serious debate about how to approach this contentious policy area. We do not

seek to end the debate by demonstrating the superiority of one solution; however we are concerned to ensure that the debate is as informed as possible using the data that is available.

59. We examine the following possible options available to policy makers in the next 5 chapters.
- Improve the contract and performance management of PFI schemes.
 - Centralise part of the PFI interest payment to alleviate the financial burden on local NHS trusts.
 - Use a windfall tax to deal with the excess profits made by PFI companies.
 - Terminate or buyout the PFI contracts.
 - Nationalise the PFI operating company (the SPV).
60. The policy options set out here should also not be considered mutually exclusive. Thus it may be possible in some instances for policy makers to centralise PFI debt repayments within the NHS whilst also seeking to manage and enforce the contracts more effectively. Or government could selectively purchase the equity in some PFI schemes in order to re-finance the debt, whilst more generally imposing a tax on the profits made on all PFI schemes to reduce excessive profit making. In this sense these options should be seen as a possible toolkit for dealing with the legacy of PFI.
61. We recognise that making a decision about which option to use is likely to be influenced by the particular concerns of individual policy makers. For example, some policy makers may be comfortable with the outsourcing of public services but might object to the high cost of PFI. In order to provide a further indication of which option may be most attractive table A3 sets out the extent to which each solution seeks to address 3 common objections:

Table A3 – Policy options and the objections that they seek to address

Option proposed	Objection(s) addressed		
	Financial burden of PFI	Poor value for money/excess profit making	Outsourcing of services
Improve the contract and performance management		✓	
Centralise part of the PFI interest payment	✓		
Windfall tax on excess profit making		✓	
Terminate or buyout the PFI contract	✓		✓
Nationalise the PFI operating company (the SPV)	✓	✓	✓

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Part 2: Assessment of the Options

Option 1: Improve the contract and performance management of PFI schemes

Introduction

1. This chapter looks in detail at the potential gains from improving the public sector's management of PFI contracts in the NHS in order to reduce costs and improve performance. It looks at the ways in which contract management could be enhanced through the pooling of NHS resources to monitor, oversee, and enforce PFI contracts more rigorously.
2. It is the least radical of all the options due to the fact that it works on the assumption that the existing PFI contract will remain in place. Nevertheless the analysis set out here demonstrates that there are potential savings to be made.
3. As noted above, the performance management of PFI contracts is resource intensive and the NAO has found that the public sector often lacks the skills and the data to exploit the contractual relationship to its benefit.
4. However, improving PFI contract management can lead to better quality public services and can reduce the cost of PFI to the public sector. This is due to the fact that more active contract management by public bodies can reduce the annual payments made to PFI contractors – in essence, deductions from the payments to PFI companies can arise through the better identification of poor performance. Overall, this improves the “value for money” of PFI contracts.
5. The extent to which savings are possible under this approach can be estimated using data from a survey of NHS PFI schemes undertaken by the regulator of NHS Trusts, NHS Improvement (NHSI) in 2017.ⁱ

How deductions under PFI contracts are made

6. PFI contracts contain agreed availability and service quality levels for the life of the contract. These specify the availability of usable space in the PFI building and the quality of the services provided (e.g. building maintenance, cleaning, portering) in return for the annual unitary payment.
7. The potential for reductions in the amount of the annual unitary charge payment paid is the primary way to incentivise a PFI project company (the SPV) to perform well. As the PFI project company often contracts out

ⁱ The results below are based on the responses of 81 trusts which had a PFI contract running for over a year and which gave complete responses to the Survey.

facilities maintenance (e.g. building repairs) and soft services (e.g. cleaning, meals) to other companies, those contracts will often pass on any penalties to the sub-contractors responsible.

8. The two main deductions under a PFI contract are for unavailability or underperformance.

Unavailability deductions are made when part of the PFI building is unavailable for use. This may be due to it not being safe to use (e.g. temperature, cleanliness), lacking basic services (e.g. electricity, water), or the unavailability of key areas (e.g. toilets).

Performance deductions are made when the quality or frequency of a service are not at the agreed levels (e.g. cleaning standards, frequency of reporting).

9. For a public body, the fact that a school or a hospital is unavailable for any period of time is a significant issue and so the penalty for unavailability is higher than for performance issues.
10. The contract will typically specify criteria for availability and performance. If any of these criteria are not met by the PFI provider a corresponding deduction can be levied by the public sector. For unavailability deductions, there is usually a 'rectification period' during which no deductions are levied if the issue is addressed. If the issue has not been fixed after this period has passed then deductions are levied.
11. In most contracts deductions for unavailability are usually a percentage of the total unitary payment, equal to the percentage lost out of the total space to be provided; thus if the entire PFI building was unavailable the SPV would lose all of the unitary payment for the period.
12. Performance deductions can be levied on a cumulative points basis (with each point equal to a fixed fine), or on scale depending on how critical the failure is.

The size of the deductions made in the NHS

13. Using the results from the NHSI survey of NHS hospital trusts with PFI obligations gives an indication of the size of deductions which were levied in 2017. In 12 months a total of £10.7m of deductions were levied by 36 trusts due to the unavailability of facilities. This amounts to 1.1% of the total unitary payments made by these 36 NHS trusts in that year.
14. A further £6m of deductions were made by 44 trusts over 12 months due to poor performance, which amounts to 0.5% of the total unitary payment made by these 44 NHS trusts in that year.
15. There are a number of limitations to the wider applicability of these findings. Firstly, it is important to note that 83% of the £10.7m in unavailability deductions, by value, were made by just four trusts. With the majority of PFI

contracts having run for over a decade, most building unavailability issues would be expected to have been remedied, so the ability of NHS Trusts to reduce costs in this way in future is expected to be limited.

16. In addition, the type of contract which exists between the NHS Trust and the PFI project company is also a factor – those Trusts with a non-Standard PFI contract reported experiencing greater difficulty in imposing performance and availability deductions. Of the 81 trusts: 31 had standard form contracts on all their PFI projects, 12 had some standard form and some not, leaving 38 which either did not have standard form contracts or which answered that they were not sure.
17. Monitoring and access to key information on performance is also necessary to be able to identify when services are below the contractual standard and enabling penalties to be levied. Yet 17 out of the 81 trusts reported not being given access to this information by the PFI project company. This again is likely to affect the size of the deductions made.

Table B1: PFI performance and unavailability deductions levied across 81 trusts in the twelve months to Summer 2017ⁱⁱ

	Value of deductions due to the unavailability of facilities	Value of deductions due to poor performance by the contractor
Total	£10,699,705	£5,911,613
Average deduction per Trust	£297,214	£134,355
Median deduction per Trust	£17,662	£33,799
As a % of annual unitary payment	1.1%	0.5%
Number of trusts with a deduction levied	36	44

Source: NHSI PFI Survey (2017)

Potential savings to be made

18. In terms of estimating the overall benefit to the NHS of more active contract management, if all 95 trusts with a PFI scheme (and known unitary payment) were able to make deductions (as a proportion of their unitary payments) at the same rate as the median of the upper quartile of trusts (based on the NHSI survey) then:
 - The NHS could save £14m a year using unavailability deductions,
 - The NHS could save £15m a year using performance deductions.
19. This is a very rough estimate, though: it relies on one year of data on deductions so may not be representative over time; unavailability deductions are concentrated in a small number of trusts so are less likely to be replicable than performance deductions; and not all trusts will have

ⁱⁱ The survey asked for the number of deductions applied over the past 12 months.

standard form contracts and access to the information required to facilitate deductions. However, further savings and better value for money services could be extracted through a focus on estates and FM savings, which are looked into below.

Other ways of reducing the cost of PFI

20. In the NHSI survey, NHS Trusts were also asked to report the savings they had made over the past two years in estates and facilities management. In total £42 million was saved by 31 Trusts in Estates and £32 million was saved by 25 Trusts in Facilities Management.

Table B2: Savings made across 81 trusts in the two years to Summer 2017ⁱⁱⁱ

	Estates savings	Facilities Management savings
Total	£41,565,552	£32,032,331
Average	£1,340,824	£1,281,293
Median	£464,549	£792,000
As a % of two years of unitary payments	2.0%	1.5%
Number of trusts reporting a saving	31	25

Source: NHSI PFI Survey (2017)

21. These savings are concentrated in a smaller number of NHS Trusts than the two deductions above, but many of them are sizable and recurrent. For those trusts which provided further detail the savings were made in the following areas:

Table B3: Estates savings made across 81 trusts in the two years to Summer 2017

Saving category	PFI/Non-PFI related	Number of trusts	Total size of saving made
Refinancing gain	PFI	1	£10,600,000
Land sales	Both	3	£6,600,000
Energy gain share/utilities cost in contract	PFI	12	£3,522,263
Insurance gain share/rebate	PFI	7	£3,277,527
Business rate rebates	Both	3	£1,329,465
Car parking fees increase	Both	5	£706,334
Combined heat and power	Both	3	£340,102

Source: NHSI PFI Survey (2017)

ⁱⁱⁱ The survey asked for the number of deductions applied over the past two years. Most responses were received in June 2017 however some were received after this deadline.

22. As can be seen, refinancing gains – whereby the PFI project company initiates a reduction in the cost of its debt – can be the most effective way of reducing costs to the public sector, with one Trust making a total saving of £10.6million in the period 2015-17. However, the public sector is rarely in a situation where it can require the PFI project company to refinance its debt and so is reliant on the private sector to initiate such a move.
23. In circumstances where the PFI project company is able to reduce its cost of insuring the facilities or the cost of the energy or utility bills that it pays, these savings can be passed onto the NHS Trust. These savings generated around £6.7m for NHS Trusts over 2 years.
24. It should be noted that the NAO has found that PFI project companies often have little incentive to make and share savings relating to their costs of insurance, although reductions in the cost of energy bills are more feasible for many trusts.¹
25. One interesting aspect of the survey is that some NHS Trusts have increased the charges for the use of hospital car parking facilities, for staff members and patients. This additional income stream from car parking charges can be used to fund the unitary charge payments to the PFI project company. Clearly such a strategy moves the cost burden away from the Trust and onto patients and staff members and so is a regressive approach and would be deemed highly controversial if adopted widely as a policy.

Table B4: Facilities Management (FM) savings made across 81 trusts in the two years to Summer 2017

Saving category	PFI/Non-PFI related	Number of trusts	Size of saving made
De-scoping soft FM from PFI contract and retendering	PFI	1	£8,000,000
Market testing saving/ benchmarking	PFI	7	£5,755,981
Cutting scope of services provided	PFI	9	£5,660,000
Payment mechanism disputes	PFI	2	£3,283,000
Retender FM contracts	Non-PFI	2	£3,250,000
Phasing down Retention of Employment model / use of contractors	Both	4	£2,155,000

Source: NHSI PFI Survey (2017)

26. One of the more problematic aspects of many PFI contracts is that they require NHS trusts to sign up to a facilities maintenance contract (e.g. for cleaning and building maintenance) for a 25-35 year period at a fixed cost (which rises annually with inflation). This leads to a great deal of inflexibility for the public sector but it also means that they are locked into paying higher prices than they otherwise might do if they took the services back in house – e.g. if they provided the cleaning directly using NHS staff – or put the contract for cleaning out to competitive tender by another private company.

27. As the above table shows, for most trusts taking services out of the PFI contract and re-tendering them would save a lot of money. However, due to the way that the contracts are written, this is not possible without compensating the PFI project company for lost income. The only NHS Trust in the survey which did achieve this used the threat of terminating the contract early, due to a serious breach, in order to negotiate a de-scoping.
28. It is more likely that the NHS trust could identify the extent to which the amount they are paying for facilities management services is higher than the market rate and negotiate with the PFI project company on this basis. As is shown above, this form of ‘benchmarking’ is usually possible under existing PFI contracts and it reduced the costs of PFI by around £5.7m in 7 Trusts over two years. However the PFI SPVs can be uncooperative, the trust may not have access to key performance information, and benchmarking may lead to prices going up as well as down.
29. Cutting the scope of services provided – i.e. reducing the amount of work that the PFI project company undertakes under the contract – reduces the amount paid to the company. However, this is dubious in terms of a real saving, as it would not necessarily lead to improvements in the value for money, as less is being provided for a lower cost.
30. A more controversial approach to reducing the cost of PFI for an NHS Trust is to seek to remove some of the protections over the working terms and conditions granted to those NHS staff – mainly staff involved in the delivery of soft facilities management services such as portering and cleaning – who transferred from NHS employment to the PFI SPV’s contractors when the PFI contract was signed. This is referred to in the survey by one trust as “the phasing down of the Retention of Employment (RoE) model”.
31. Reducing the amount paid to PFI contractors because the contractors are employing staff on less favourable terms is – like increasing car park charges – transferring the cost of paying for PFI contracts away from the tax payer and onto workers. Thus the £2.1 million in savings identified above is in effect a reduction in pay and pensions for workers. This does however fit with a wider trend whereby less generous working conditions are becoming a more common occurrence across the wider hospital sector.²

Potential benefits from pooling NHS staff to undertake contract management

32. In order to increase the chances of achieving the savings identified above it is necessary for NHS trusts to dedicate time and resources to active contract management. The NHSI survey shows that Trusts with larger PFI projects tend to have more whole time equivalent (WTE) project and

contract management staff working for them per PFI project, which seems to influence their ability to manage the contract better and leads to higher deductions for underperformance when it occurs.

33. Twelve NHS Trusts reported no performance deductions in the year, despite having standardised contracts. These trusts had smaller PFI contracts (measured by the percentage of their income which went on PFI). For Trusts such as these twelve the relatively small size of their PFI projects means active contract management only becomes economical if they can share the cost of expertise by pooling contract management staff with other NHS Trusts.
34. The recent NAO report into PFI found that there is no centralised coordination of efforts to make savings – NHS trusts are free to engage with different consultancy firms for savings advice. This may reduce the chance that lessons can be learned and shared across the public sector.¹
35. However, the NHSI survey revealed that 46 of the 81 trusts in the survey had used significant formal legal input in the last two years. Pooling could therefore be used to employ staff to monitor and assess contract performance, negotiate changes, or provide legal advice.
36. Pooling this type of resource could be undertaken by NHS region, or grouped by trusts with the same service providers.
37. If done **regionally** the pooling could be co-ordinated by NHS Improvement, which has regional offices. Trusts with PFI schemes could pay in their share of the cost of the resource used. As can be seen in Table B5, the trusts which have the largest number of WTE staff engaged in managing or monitoring PFI projects tend also to have proportionately larger PFI payments (as a proportion of their operating expenses). The trusts which employ the fewest staff do so despite having reasonably large PFI projects.
38. Thus there is scope for the sharing of staff regionally, given the niche skills that PFI contract monitoring can involve and the staffing disparities between the trusts. Overall the eighty-four trusts which provided a response had between them a total of 202.22 WTE staff managing and monitoring PFI contracts, with total annual unitary payments of over £1.8bn.

Table B5: Whole Time Equivalent (WTE) staff engaged in managing or monitoring PFI projects by region.

Region	Number of PFI trusts covered	Average WTE per PFI	Max WTE per PFI	Min WTE per PFI	UP % of opex		Total WTE in region
					Max WTE trust	Min WTE trust	
London	13	2.42	5.00	0.10	10.20%	0.80%	40.85
Midlands and East	31	1.86	10.00	0.00	13.10%	3.10%	72.83
North	22	2.27	8.96	0.00	14.70%	8.40%	57.96
South	18	1.21	5.50	0.00	9.40%	0.70%	30.58
Total	84						202.22

NB. Trusts which answered that they had 'Three or more' PFI schemes were treated as having three. 'opex' stands for operating expenses.

Source: NHSI PFI Survey (2017)

39. If trusts with the same **service providers** pool resources there could be scope for easier negotiation and more coordinated benchmarking. These providers are contracted by the PFI SPVs to carry out FM services. Tables B6 and B7 show the most common providers of hard facilities management (e.g. building maintenance and repair) and soft facilities management (e.g. cleaning).

Table B6: Most common service providers of hard facilities management by number of trusts

Service provider	Number of trusts
Carillion	11
ENGIE	8
Interserve	8
Rydon	7
Grosvenor Facilities Management	6
Sodexo	6
Vinci	6
Bouygues Energies and Services	5
Skanska	4
FES Group	3
JLL	3

NB. Some trusts have multiple service providers for FM. The survey was taken before the liquidation of Carillion commenced so it is uncertain who provides their services now.

Source: NHSI PFI Survey (2017)

Table B7: Most common service providers of soft facilities management by number of trusts

Service provider	Number of trusts
Not part of PFI contract	41
ISS World	8
Sodexo	7
Carillion	6
Trust	6
Interserve	5
Medirest (Compass Group)	5
Aramark	3
Grosvenor Facilities Management	3

NB. Some trusts have multiple service providers for FM. The survey was taken before the liquidation of Carillion commenced so it is uncertain who provides their services now.

Source: NHSI PFI Survey (2017)

40. As Table B7 shows, the number of trusts with PFI contracts that do not include soft FM is relatively high, which acts as a further limit to the scope of savings possible.

Analysis of improved contract management

41. The option available to policy makers to reduce the high costs of PFI is to work within the existing contractual framework but take a more co-ordinated and rigorous approach to enforcement.

Advantages

42. As demonstrated above, the NHSI survey reveals that even when the NHS does not take a pro-active co-ordinated approach to contract management it has succeeded in generating over £16.6m of contractual deductions over the past year, and a further £73.6m in wider PFI related savings in the past two years.
43. Out of these savings we would not consider the introduction of higher car parking charges or a reduction in the terms of conditions of workers as legitimate savings, as these merely transfer the costs of PFI away from the public and private sector and onto workers and patients.
44. However in other respects, we consider that the savings identified by the NHSI survey could be considerably enhanced through the pooling of NHS resources at a national or regional level.

- 45. This solution has the advantage that it does not require legislative changes and that the structure to operate a regional pooling of staff/expertise already exists. Trusts in local areas are already co-operating under Sustainability and Transformation Partnerships (STPs) and identifying PFI savings has formed part of the cost reduction strategy for some STPs.
- 46. In addition, compared to other solutions considered in this report it is practical and achievable for higher performing trusts to partner up with others to help share best practice and staff to generate additional savings.

Disadvantages

- 47. The scope of the savings possible may be hindered by a number of factors that are outside the control of hospital trusts individually and collectively. The survey responses show that for the trusts without standard form contracts (up to 38), making deductions is not always possible or straightforward. Seventeen trusts did not have access to key performance information on the contractors, whilst seven did not have access to the PFI contracts on an electronic system. These factors limit the number of trusts where contractual deductions could be made. In addition, as staff are likely to be involved in non-PFI work too there may be limits to how easily they could be shared between trusts although best practice can still be.
- 48. The scope for savings is also likely to be initially limited to performance deductions, £15m a year being a small sum compared to the scale of financial difficulties facing trusts, and the potential costs of collaboration. The potential savings from estates or FM contract management would often be recurrent and far more substantial but would require a co-operative PFI SPV (which isn't always the case) and support from central government to encourage negotiation.

Feasibility

- 49. This solution could be implemented quite rapidly within the existing structure of hospital trusts and STPs. As a first step to tackle some of the issues around PFI it would be an easy one to implement but its long-term efficacy would be limited without more central support.
- 50. More could be achieved if the government used its negotiating power directly with PFI SPVs and their contractors. The ownership of PFI SPVs is highly concentrated, with eight companies owning equity stakes in 92% of NHS PFI contracts.³ These owners consist of investment companies and construction firms. The concentration of ownership provides an opportunity for central government to negotiate better access to key PFI performance information, refinance debts, and amend poor value for money contracts. In this way a more proactive role by government could counter many of the disadvantages listed for this solution and increase the value for money of these contracts by far more.

Conclusion

51. Many of the statistics presented in this solutions paper are concerned with the size of deductions and cost savings made possible through more engaged contract management. However even if costs stay the same, but the quality of services provided improves and is maintained at contractually agreed levels, it would represent an improvement in the value for money of PFI contracts.

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Option 2: Centralise part of the PFI interest payment to alleviate the financial burden on local NHS Trusts

Introduction

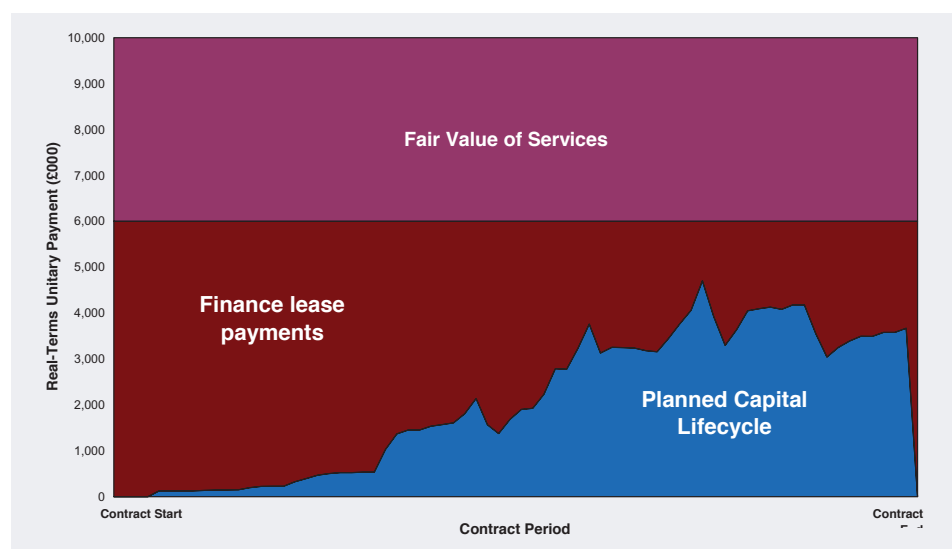
1. The responsibility for making payments to PFI project companies is often devolved to local public bodies such as local authorities and NHS Trusts. As a result the financial burden of the existing PFI legacy is distributed unequally across England, meaning that some NHS Trusts are more affected than others. Payments under PFI contracts must be paid, irrespective of the financial situation of the NHS Trust, so those Trusts with large PFI schemes are increasingly required to cut or underfund services in order to meet their contractual payments.
2. This is particularly a problem in the context of underfunding in the NHS, where many NHS Trusts and local authorities are experiencing significant financial difficulties and are struggling to meet all their statutory duties to fund public services to a given level of quality. This means that wider access to healthcare and other public services for any given population is affected by whether the local NHS or local authority has to make PFI payments.
3. Although the global cost of PFI to the Department of Health is around 1.6% of its annual revenue budget, this masks the impact at local trust level where in some Trusts the percentage of income can vary widely, from 0.1 to 15.5%. It is also the case that the cost of debt under a PFI scheme is far higher than if the government borrowed directly.
4. It could be argued that the decision by central government to require NHS Trusts to borrow at this higher rate to fund the new hospitals means that there is a requirement on central government to take on any additional costs associated with PFI over and above the government borrowing rate.
5. This chapter looks at a potential solution to this issue by examining how the centralisation of PFI payments in the NHS might alleviate some of the burden on specific NHS Trusts and share the costs of PFI across all of the NHS. The solution acknowledges that the local public bodies which have PFI deals benefit from the capital infrastructure (a new hospital or school) and so it does not suggest that NHS Trusts should make no financial contribution to meeting these repayments.
6. Trusts with a PFI scheme get a new building or equipment (to an agreed standard) which is maintained over the lifetime of the contract. It could be considered fair that they pay fully for the cost of building and maintaining these new assets, as they receive the benefits. In addition there is an 'interest rate' charged for the spreading out of the building cost over the life of the contract.

7. This interest rate (known as the ‘finance rate’) is on average a lot higher than if a trust borrowed from the government. This solution quantifies how much individual hospital trusts could save if they only paid interest at a government-financed rate, with the remainder being paid centrally, and the impact this would have on their financial sustainability.

Calculating the “finance rate” for NHS PFI schemes

8. In order to identify what the higher borrowing costs of a PFI scheme are, over and above the associated government borrowing rate, it is necessary to isolate the actual cost of the building plus the associated interest.
9. When a PFI agreement is drawn up, a schedule of annual payments (the ‘unitary payments’) is set for the lifetime of the project. These annual payments can be split into payments for the following:
 - a) Maintenance and other services (e.g. cleaning) provided as per the PFI contract.
 - b) Planned contractual maintenance/asset improvements (‘lifecycle’) throughout the contract.
 - c) The cost of building, plus interest.
10. To calculate the cost of building plus interest, the inflation-adjusted value of services provided and the planned lifecycle spend is deducted from the unitary payment. This is done up-front for every year of the contract.

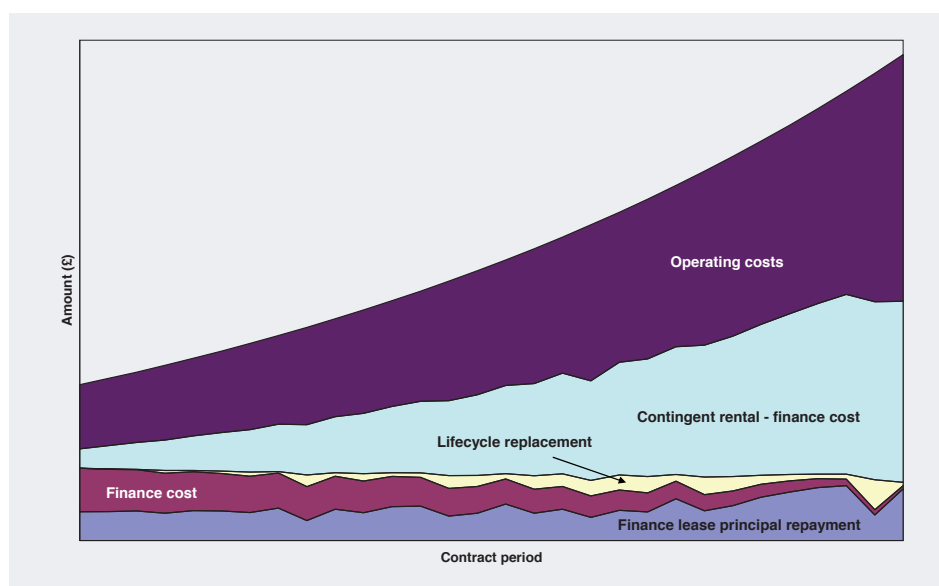
Figure C1: Example of how the total unitary payment is split to calculate the cost of building plus interest (‘the finance lease payments’) – all in real terms.



Source: Department of Health and Social Care (2009)¹

11. The remaining payment – after deducting the costs of maintenance and providing services from the total annual payment – is the amount paid towards the cost of building (principal) and interest (together known as the ‘finance lease rental/payment’). The ‘finance rate’ is set so that the full amount owed over the contract is paid back by the end of the PFI contract as a combination of interest (‘finance cost’) and principal (‘finance lease principal repayments’) payments.
12. This ‘finance rate’ is effectively an interest rate for paying for the cost of building over the lifetime of the contract, similar to a home mortgage. The ‘finance rate’ can be very high relative to borrowing from the government. In addition, part (or all) of the unitary payment will be indexed to rise with inflation every year. For services and lifecycle spend this will be included as part of their cost, whilst for the lease/rental payments, any increases due to inflation are included as a separate cost called ‘contingent rental’.ⁱ

Figure C2: Example breakdown of the costs of the contract over the contract term in cash terms, with a unitary payment fully indexed to inflation.



Source: Department of Health and Social Care (2009)

13. The rate of inflation used in PFI contracts is RPI (Retail Prices Index) inflation. This inflation measure is generally a lot higher than the government’s preferred measures of inflation CPI (Consumer Price Index) or the GDP deflator, which are used for calculating increases in departmental budgets to offset inflation. As an inflation measure RPI is no longer considered an ‘official statistic’ and does not meet international standards, but it is still used in PFI contracts.²

ⁱ Under IFRS accounting standards on balance sheet PFI obligations are accounted for as a finance lease. For more information please see: International Accounting Standard (IAS) 17 – Leases.

The finance rate for NHS trusts with PFI schemes

14. Using their accounts, we have calculated the finance rate for 99 NHS Foundation Trusts and NHS Trusts with a PFI scheme.

Table C1: Finance rates for the PFI schemes of 99 NHS Foundation Trusts and NHS Trusts, using data for the financial years 14/15 to 16/17.ⁱⁱ

Measure	Finance rate
Aggregate (across all trusts)	5.4%
Average (Mean)	7.0%
Median	6.4%
Maximum	19.3%
Minimum	2.6%

Source: NHS Trusts accounts. NHS Foundation Trusts accounts.

15. As Table C1 shows, the average interest rate being paid by these trusts for their PFI schemes is 7.0%, which is far above the interest rates for government borrowing. It can be argued that it is unfair for NHS trusts to have to pay such high interest rates for their PFI schemes compared to other hospital trusts which have received government financing for building projects or equipment.

How much could be saved by NHS trusts if they paid lower interest rates?

16. Before calculating the interest saved it is important to determine a fair interest rate to be paid instead. If the hospital trusts had needed to finance building the assets using Department of Health and Social Care financing they could have received it either as an equity-style investment ('Public Dividend Capital') or as a capital investment loan.³ Whilst the interest rates for capital investment loans are not publicly available, the rate of return for Public Dividend Capital is 3.5% on net assets.⁴ Using this as the comparator interest rate we can estimate how much interest the 99 trusts would be paying if they had been financed with Public Dividend Capital.ⁱⁱⁱ

ii We assume that the PFI unitary payment is made in arrears. Finance rates are generally consistent across years (as expected) and the effect of mergers and FT authorisations has been accounted for. Anomalous years (with one-off variations) were excluded from the calculation. For trusts with multiple PFI schemes the aggregate finance rate was calculated.

iii This assumes that the cost of building would have been substantively similar if procured and financed directly by the trusts. So only the interest paid is expected to change.

Table C2: Interest paid ('Finance costs') under PFI finance rates versus amount paid if at 3.5% for 91 NHS Foundation Trusts and NHS Trusts.^{iv}

	Financial Year			
	2014/15	2015/16	2016/17	Total
Actual Finance costs (interest paid)	£531.7m	£514.4m	£506.5m	£1,552.6m
Cost to the government of meeting the costs of all interest over 3.5%	£207.6m	£205.6m	£199.2m	£612.4m
Finance cost for trusts (if rate set at 3.5%)	£324.1m	£308.8m	£307.3m	£940.3m
Amounts centralised as a % of annual unitary payments	11.7%	11.3%	10.6%	11.2%

Source: NHS Trusts accounts. NHS Foundation Trusts accounts.

17. Over the past three financial years, centralising the excess part of the PFI interest payment would have saved these 91 trusts over £612m, which is 11.2% of their annual unitary payments over those years.
18. Centralising this excess interest payment would have a significant impact on their deficits. As an illustration, in 2016/17 centralising the excess interest payment would have reduced the total deficit across the 91 trusts by 13.9%, whilst without one-off Sustainability and Transformation Funding (STF) (provided to lower the deficits of trusts in 2016/17) the amount saved would be 8.8%. This would improve their financial sustainability whilst still leaving them paying a reasonable rate for the benefits they have received from the PFI buildings.

Table C3: Reduction to surplus/(deficit) in 2016/17 if the in-year excess PFI interest costs were centralised for 91 NHS Foundation Trusts and NHS Trusts.^v

	Surplus/(Deficit) ^{xv}	Sustainability and Transformation Funding (STF)	Surplus/(Deficit) without STF
Original amount	£(1,437.5m)	£837.2m	£(2,274.7m)
Amount less centralised excess interest payment	£(1,238.4m)	£837.2m	£(2,075.6m)
% change from original to adjusted	-13.9%		-8.8%

Source: NHS Trusts accounts. NHS Foundation Trusts accounts.

^{iv} Seven trusts were excluded from the calculation because their finance rates were below 3.5% and so they arguably are already paying a fair interest rate. One further trust was excluded as its unitary payment information was unavailable.

^v For NHS Foundation Trusts this is 'Surplus/(Deficit) for the year'. For NHS Trusts it is 'Retained Surplus/(Deficit) for the year'.

How much could be saved by NHS trusts in future if excess interest costs were centralised?

19. Without reviewing the financial models held by trusts it is hard to obtain a precise figure, but an estimate can be obtained using trust accounts. In total, trusts expect to pay £9.0bn in interest costs from 2016/17 until the end of their PFI contracts.^{vi}
20. If the amount of excess interest centralised stayed consistent at 39% (as in the three years studied), this would equate to approximately £3.5bn of interest charges being paid centrally instead of by trusts over the remaining life of the PFI contracts. However, as a caveat: as with a mortgage, the proportion of each payment that goes to paying interest falls over time (as more of each payment pays down the building cost, i.e. the principal), so the estimate of £3.5bn is an upper estimate.

What about the costs of inflation?

21. As mentioned earlier, part (or all) of the unitary payment will rise with RPI inflation every year. For the services and lifecycle spends this will be included as part of their cost, whilst for the rental payments, any increases due to inflation are included as a separate cost called 'contingent rent/rental'.
22. It could be argued that this inflation cost is an unnecessary burden on trusts because if they took out a loan, the repayments would not rise with inflation over time – indeed they would fall in real terms. For example, home mortgage repayments do not change with inflation, but only with changes in interest rates. This inflation cost is expected to dwarf the interest repayment over the life of the contract. For an illustration refer back to Figure C2 and see the difference in size between the inflation cost ('contingent rental') and interest cost ('finance cost') over time.
23. For the PFI operator this 'contingent rental' is an additional windfall because, first, its income will rise with RPI yearly, whilst the costs of providing services will only rise in line with the (generally lower) CPI inflation rate. Second, their loan repayments do not rise with inflation but fall in real terms over time.
24. In the three years studied the contingent rental costs were larger than the excess interest costs. If the excess interest costs and inflation costs were both centralised then this would improve the financial position of trusts with PFI even more.

^{vi} Usually described as finance charges allocated to future periods/interest element in the accounts note which shows on-SOFP PFI service concession liabilities.

Table C4: Interest costs and contingent rent centralised for 91 NHS Foundation Trusts and NHS Trusts.

	Financial Year			
	2014/15	2015/16	2016/17	Total
Finance costs paid by government (interest costs above 3.5%)	£207.6m	£205.6m	£199.2m	£612.4m
Contingent rental	£208.7m	£214.3m	£233.7m	£656.6m
Total amount paid centrally	£416.3m	£419.9m	£432.9m	£1,269.0m

Source: NHS Trusts accounts. NHS Foundation Trusts accounts.

25. Over the three years £1.3bn has been paid in excess interest costs and contingent rent. If both the contingent rent and excess interest charges were centralised for the year 2016/17, this would reduce the overall deficit in 2016/17 (including STF) for the 91 trusts by 30.1%. This would significantly improve their financial sustainability whilst still allowing them to pay a reasonable rate for the benefits they have received from the PFI buildings.

Analysis of Centralising part of the PFI interest payment

Advantages

26. This solution has the advantage that it does not require any legislative changes and addresses the issue of PFI adversely affecting the financial sustainability of trusts. By making trusts continue to pay for services provided, and for the cost of building at a fairer interest rate, it attaches a reasonable cost to the benefits that they receive.
27. If implemented, the burden of excess interest charges, or both excess interest charges and contingent rent, would be paid by the Department of Health and Social Care. This additional cost of £199m for meeting the excess interest charges in 2016/17 would represent 0.17% of the Department's revenue budget in that year. The additional cost of £433m in 2016/17 for meeting both the excess interest charges and contingent rent would amount to 0.37% respectively of the Department's revenue budget in that year.⁵
28. This additional cost to the Department would require a diversion of funds away from other funded activities, but it would be easier to manage than for the 91 NHS Trusts where the cost of excess interest charges in 2016/17 represents 0.49% of their total income in that year, and the cost of interest charges and contingent rent would be 1.07% of their annual income.

Disadvantages

29. This solution represents a transfer of some of the financial costs of PFI from smaller (NHS trust) budgets to the larger Department of Health and Social Care budget. As such it does not address the excess profits to the lenders and owners of PFI projects, and so does not deal with the problem of the higher costs of PFI but merely transfers the responsibility for making payments within the NHS.
30. In addition, the Department of Health and Social Care's overall financial position is under significant stress. In 2016/17 the Department's revenue budget was only underspent by £563m (a very small margin for a government department), whilst in 2015/16 there was an overspend of £207m.⁶ With funding very tight it is also questionable whether it is desirable to offer financial relief to some NHS trusts at the expense of other NHS trusts or at the expense of centrally-funded budget areas, such as spending on public health. Reducing spending on these core areas without also reducing the overall cost of PFI to the taxpayer may be considered undesirable.

Feasibility

31. This solution could be implemented through the use of income credits to NHS trusts. This mechanism already exists for PFI, with six NHS Foundation Trusts receiving £21m of PFI credits in 2016/17.

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Option 3: Use a windfall tax to deal with the excess profits made by PFI companies

Introduction

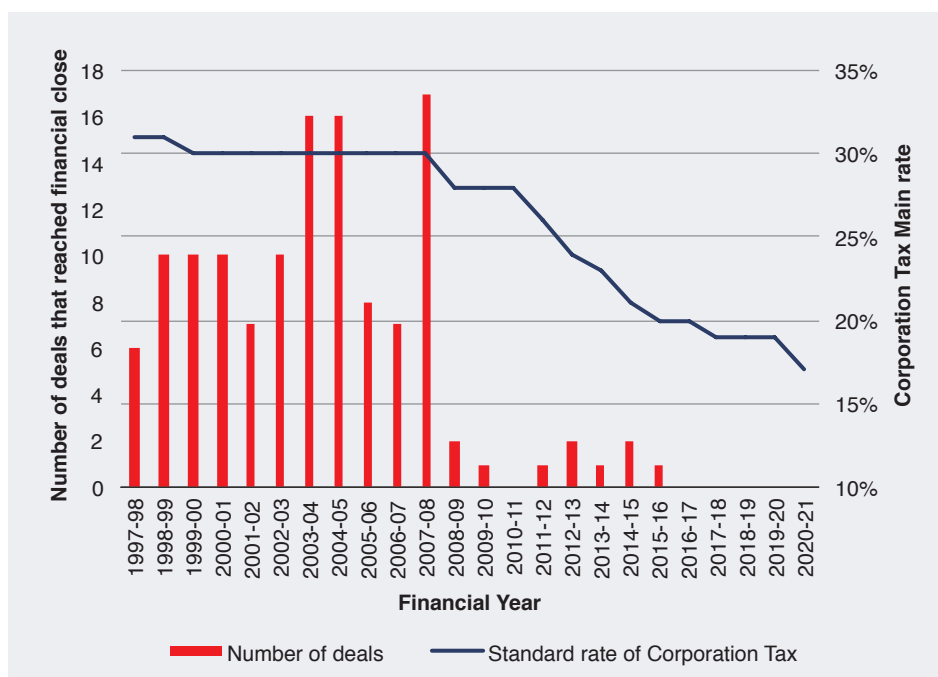
1. A recent CHPI report found that over the past six years PFI companies have made pre-tax profits of £831m out of the NHS and are estimated to make profits of almost £1bn over the next 5 years.¹ As discussed in the introduction to this report there is evidence that the rate of returns for shareholders in PFI schemes is greater than expected, given the risks to private investors associated with PFI schemes and the cost of raising finance.^{2 3}
2. The option discussed in this chapter looks at the advantages and disadvantages of using the tax system to claw back some of these excess profits and in doing so use the receipts from the tax to fund NHS services. A levy on PFI companies could also be used to encourage investors in PFI contracts to reduce the overall costs to the public sector in order to avoid paying such a tax.
3. Taxes on excess profits by private companies providing public services have been used previously, with the Labour government in 1997 introducing a windfall tax on the profits of the privatised utilities.ⁱ
4. In order to justify such a tax it is necessary to identify the excessive returns which the private companies have made and the extent to which these returns can be shown to be illegitimate. Otherwise there are likely to be wider implications for government tax policy and a concern that tax powers are being employed arbitrarily. This could discourage investment in the UK economy and create instability for investors. It might also raise issues relating to property rights which could result in legal challenge.
5. In order to demonstrate how such a policy might work we set out below how a tax on the excess profits of PFI companies could apply to the gains made by PFI companies as a result of a reduction in the corporation tax rate on their profits after the initial contracts were signed. This is one potential option for government and it is used here as a way of exploring the possible advantages and disadvantages of a taxation based option.

i See for example: <https://web.archive.org/web/20070928040614/http://archive.treasury.gov.uk/pub/html/budget97/ir1.html>

The justification for clawing back the gains made by PFI companies as a result of the reduction in the corporation tax rate

6. When PFI deals were designed and negotiated they included an expected rate of return for the investors along with agreed payments over the lifetime of the contract (on average 27 years for health contracts). These contracts offered a relatively secure rate of return for the PFI investors and explicitly removed the financial risks associated with inflation and changes in interest rates. They did this by linking the payments made by the public sector to the cost of inflation and by using financial instruments (such as swaps) to insulate the PFI companies against the possible negative impact of interest rate changes by the Bank of England.
7. One of the modelled costs in the contract was the expected corporation tax rate that would be paid by the investors on their profits. The majority (92%) of NHS and social care PFI contracts were agreed and signed when the corporation tax (standard) rate was 30% in 2008 (see figure D1 below) and so the assumptions about how much profit they would make after tax reflected this higher rate.

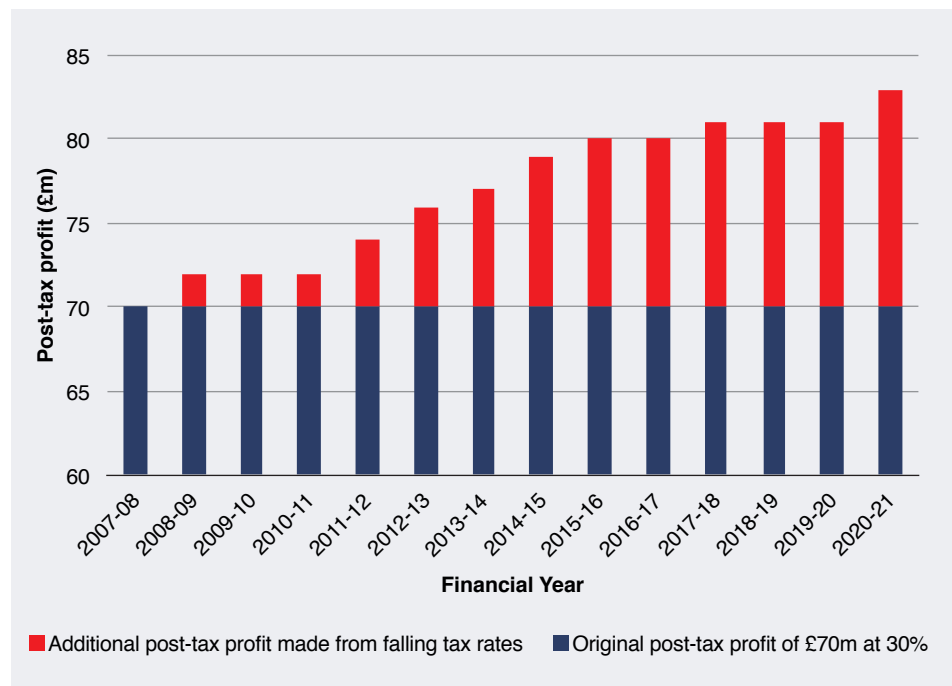
Figure D1: Health PFI deals signed and Corporation Tax rate



Source: HM Treasury. Private Finance Initiative and Private Finance 2 projects: 2016 summary data.

8. The reduction in corporation tax rates from 30% to 17% between 2007 and 2020 means that for every £100m of pre-tax profit that is made by PFI operators they will in 2021 receive £83m of post-tax profit instead of the expected £70m at the original tax rates. As a result it could be argued that consecutive falls in corporation tax rates since 2008 have provided an additional and unexpected increase in financial returns for PFI operators, in other words a “windfall”.

Figure D2: Increase in post-tax profits from falling Corporation tax rates (for every £100m of pre-tax profit made)



Would introducing a tax on PFI profits to address this “windfall” be considered legitimate?

9. Cuts to corporation taxes are intended as a means to stimulate growth and increase business investment. However, PFI operating companies have arguably contributed less to the economy and exchequer than they might otherwise have done, because they have certain distinctive features compared to typical businesses. These include the following:
- Ordinarily businesses’ revenues and profits will be generally uncertain each year, whereas PFI operators have fixed and agreed revenue and costs over an average period of 3 decades. Any tax cut provides additional financial benefits over what they have already provided for and expected;

- once construction is complete, the PFI operators have relatively little ongoing extra construction or investment to do, aside from contractually agreed 'lifecycle' maintenance and works, so tax cuts tend to stimulate no extra investment in the PFI scheme itself;
 - many of the PFI operating companies are sold on from the original owners to new shareholders which are often institutional investors.⁴ These investors are often based offshore and have been found to pay little, if any, tax.⁵ Many are pension funds with international investors, so any tax cut for them does not guarantee an increase in business investment in the UK; and
 - most PFI operators outsource all maintenance and facilities management to sub-contractors. Any tax cut to the profits made by the PFI company itself will not incentivise their sub-contractors to provide new investment or a better quality of service.
10. Given these features, enabling PFI operators to benefit from a lower corporation tax rate on their profits could be viewed as unnecessarily generous.
11. Moreover, levying a windfall tax that recouped the monies saved since 2008/09 would not distort the economic activity of PFI operators because the long-term contracts they signed anticipated a given rate of return which would not have forecast the tax savings they have since experienced.

How much have PFI operating companies benefitted so far as a result of the reduction in corporation tax rates?

12. Without access to each company's corporation tax return a precise overall figure cannot be supplied. However a good estimate can be made by looking at the corporation tax charge (in their published accounts) in each year from 2008 (when corporation tax rates dropped from 30%) and comparing it to the estimated corporation tax charge if tax rates had stayed at 30%.

Table D1. Tax saving made by the 105 health PFI operators with accounts available that reached financial close before 2008/09

Profits Before Tax (PBT) 2008–2015	Actual tax charge per accounts 2008–2015	Estimated tax charge (at main rate 30%) 2008–2015	Estimated tax saving due to cut in Corporation Tax
£942.6m	£198.7m	£282.8m	£84.0m

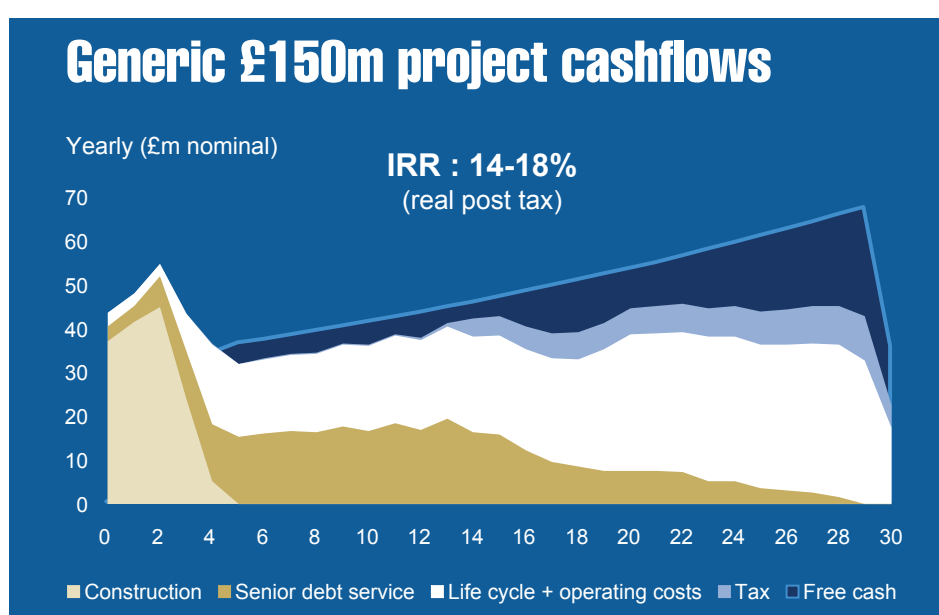
Source: Review of PFI operators' accounts available at Companies House

13. In table D1 the £84m estimated tax saving represents 9% of Profit Before Tax for the period and if paid would increase the tax charge by 42%.

How much might PFI companies benefit in the future from the reduction in corporation tax

14. PFI contracts are modelled to make low profits/losses in the early years of the contract (where they pay down their loans to banks and shareholders) and become increasingly profitable in later years, as the example in Figure D3 shows.

Figure D3. Balfour Beatty projection of cash flows from the lifetime of a PFI project.



Source: Balfour Beatty, PPP/PFI Seminar. London, June 2003.ⁱⁱ

15. Using data collected from a previous CHPI paper, and forecasting profits into the future, table D2 forecasts the future savings made from falling tax rates over the 5 years between 2016 to 2020.¹

Table D2. Forecast future tax savings made by the 117 PFI operators with health PFI schemes that reached financial close before 2008/09

Forecast Profits Before Tax (PBT) 2016–2020	Forecast tax charge 2016–2020	Estimated tax charge (at main rate 30%) 2016–2020	Estimated tax saving
£942.0m	£176.8m	£282.6m	£105.8m

Source: Forecast based on trend information from a review of PFI operators' accounts available at Companies House

ⁱⁱ Available at: https://www.balfourbeatty.com/media/29335/ppp_pfi_2003.pdf

16. The £106m estimated tax saving represents 11% of Profit Before Tax for the period and is 60% higher than the forecast tax charge at the lower tax rates.ⁱⁱⁱ

Recouping the higher costs of PFI

17. In order to calculate the extent to which the public sector and the NHS would benefit from any windfall tax we assume that the profits on the PFI companies would be taxed at the 30% rate that was agreed when the contracts were signed.
18. In doing so, the £84m savings which have already been made by the PFI companies over the period from 2008 onwards would be recouped, as well as the potential savings on the profits made going forward, which we estimate to be £106m between 2016 and 2020.
19. There are two options here to claw back this money. The first is to seek to retrospectively tax the profits already made by PFI companies. This would be highly controversial as it would provide significant uncertainty to investors and undermine the stability of the tax regime.
20. The second option is to tax the profits of the PFI companies going forward at the 30% rate, with an adjustment to cater for the windfall benefits which PFI companies have received since 2008. Whilst still controversial this would mean that the focus of the tax is on future gains rather than on profits made in the past.
21. We estimate that the total amount available to the public sector as a result of such a tax from NHS PFI schemes would be £200m covering profits made in the period 2008 to 2020.
22. However, the total amount generated would be more substantial than this. This is because the financial models which lie behind PFI deals assume that the profits available to shareholders increase significantly towards the end of the contract. Therefore the future tax receipts (as a result of a 30% tax rate applied to the profits of PFI companies) would be significantly higher. Most PFI contracts in the NHS have on average over 20 years left to run.
23. Moreover, this windfall tax could be applied across other sectors outside health. According to Treasury figures 450 of the 589 PFI schemes (across all sectors excluding health) reached financial close before the fall in corporation tax rates from 30%. We do not have data on the profits for SPVs across all these sectors.

ⁱⁱⁱ Some additional considerations concerning the accounting details behind these calculations is available here: <https://chpi.org.uk/blog/the-pfi-companies-windfall-from-falling-corporation-tax-rates/>

Analysis of Tackle/cap excess profit making

Advantages

- 24. A windfall tax, as described above, would be a relatively simple and equitable way to address excessive profits made as a result of the reduction in corporation tax rates. It would bring in additional revenue over time which would be available to fund public services.
- 25. It would have the advantage of being seen as a legitimate tax because government provided PFI companies with an unexpected windfall and it is that bonus which is being clawed back.
- 26. There is no attempt to calculate within this solution what a reasonable and legitimate rate of return should be for PFI companies. Thus it might be possible for an investor to make returns significantly over and above the cost of capital and this would be permitted. The tax on any such excess profits would under this solution be substantially higher.
- 27. The application of the tax could also be framed in a way to encourage the shareholders within PFI schemes to lower the overall cost of PFI to government. The approach outlined here would not tackle the higher cost of borrowing under PFI, merely the profits which have been made by shareholders. However, because the shareholders within the PFI company scheme are responsible for arranging the financing of the scheme (i.e. the debt), they could be incentivised to re-negotiate and re-finance the debt. The incentive would be that the tax on profits would not apply to those cases where a reduction in the interest rate on PFI loans had been negotiated.

Disadvantages

- 28. A number of difficulties with this solution have been raised when the approach was discussed by Parliament in February 2018.
- 29. The first problem is the extent to which contracts signed between public bodies and the private sector permit the introduction of so-called discriminatory taxes on PFI companies. This is a matter of legal interpretation but the clauses in the standard contract require that the costs of any taxes which affect PFI companies specifically are shared between the public authority and the private contractor. In effect this would negate any of the benefits to the public sector as the PFI companies would pass on

any additional costs of a higher tax on their profits back to the public sector through an increased unitary charge payment.^{iv v}

30. However, it is unclear from the contract terms whether this is what was intended. An alternative reading is that the taxes which are described in the contract as “discriminatory” are those which affect the cost to the private company of providing the service to the public authority. It would therefore not capture a tax on the profits made by the company which do not relate to the cost of providing the service.
31. The second problem is the extent to which this option sufficiently tackles the high costs of PFI. The estimated £200m benefit of this scheme over a 12 year period across the NHS is small proportion of both the excess profits generated and the additional costs of borrowing which have caused some NHS trusts such financial difficulties.
32. As a result the proposal would not tackle the main source of the high costs of PFI, namely the 90% of funding which is made up of debt repayments. Between 2010 and 2015 NHS PFI companies made £831m of pre-tax profit after paying £4.35bn of interest payments (for loans from shareholders and lenders). These interest payments are over five times as large as pre-tax profits.
33. It would also permit PFI companies to continue to generate significant profits over the lifetime of the contract which are likely to be deemed to be unacceptable – thus as we have identified previously, in the UCLH PFI scheme over 26% of all the payments which went to pay for PFI ended up as pre-tax profit.¹
34. A third problem is the difficulty in recouping any tax on profits. When faced with any additional tax the legitimate strategy of any private company is to minimise the impact of this on their overall profitability. Increased interest payments by the SPV to its lenders and shareholders would reduce the profits subject to a windfall tax unless the SPV’s shareholders and lenders are taxed more too.
35. In addition, as has been noted elsewhere, the investors in the PFI companies are often registered in tax havens outside of the UK’s tax jurisdiction. This means that it would be difficult to impose such a tax on the PFI SPV whilst the owners benefit from their registered ‘off-shore’ location.⁵

iv See Part Four of the Standardisation of PFI Contracts Version 4 HM Treasury 2007 which relates to “Change in Law”.

v See the arguments put forward against the Windfall Tax by Treasury Minister Mel Stride MP in a Parliamentary debate on the policy in February 2018: [https://hansard.parliament.uk/Commons/2018-02-21/debates/62222132-7F8C-4A05-928C-87920F90AB37/Finance\(No2\)Bill#contribution-CAF996AD-5970-4F9B-AA4F-D090EAF5BB5B](https://hansard.parliament.uk/Commons/2018-02-21/debates/62222132-7F8C-4A05-928C-87920F90AB37/Finance(No2)Bill#contribution-CAF996AD-5970-4F9B-AA4F-D090EAF5BB5B)

Feasibility

36. The tax could be included in legislation, such as the Finance Bill. However, there would be an administration cost to calculating and levying the tax. There is a risk that SPVs would appeal against the tax on the grounds of unfair discrimination. This would prevent or delay a windfall tax from being levied.

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Option 4: Terminate or buy out the PFI contracts

Introduction

1. The NAO identified that terminating or buying out the PFI contract would be the preferred option for most government departments.¹ This suggests that there is significant concern about the value for money and inflexible nature of the contracts.
2. This chapter explores the circumstances under which a termination of the PFI contract may be an option for policy makers. It looks at two recent examples in the NHS where the PFI contract was terminated either by mutual agreement or circumstances where the contract was terminated because of contractor default.ⁱ
3. The first of these examples, at Hexham hospital in Northumbria, involved substantial payments to the PFI company in order to release the NHS trust from the PFI contract. The funding for the buyout came from a loan to the NHS trust from their local authority. This case study has been used as an example for how PFI buyouts could work in other NHS contracts. However, to date no detailed analysis has taken place as to how much this would cost, and also whether this would be value for money for other NHS trusts. This chapter looks at the costs and assesses whether they would be value for money.
4. The second example is more recent and involves the termination of a PFI contract by Tees, Esk & Wear Valleys NHS Foundation Trust on the grounds of poor performance by the PFI operator. In this example no buyout occurred and thus far we are unaware of the value of any compensation payments made to the PFI SPV or to its lenders.
5. A recent survey of NHS Trusts with PFI schemes by NHS Improvement identified 16 Trusts – including Tees Valley – who indicated that they are or have been in a position to terminate their PFI contract at some point in the last three years.² This would amount to over 15% of all NHS trusts with PFI contracts, so the potential for the NHS to extricate itself from some PFI contracts without needing to buy them out is significant.
6. This does not mean that termination on the basis of contractor default or poor performance is cost free for the public sector and there are significant obstacles to achieving this in practice. This chapter looks in more detail at the reasons why termination of the PFI contract even when contractor default has occurred may not be the most cost effective solution for NHS Trust.

ⁱ Here we examine two of the scenarios where termination can take place. Other circumstances, such as construction flaws, will have different compensation levels and methods of redress.

Part 1: Voluntary termination and buyout of the PFI contract

7. As noted in the introduction, the PFI contracts signed by public bodies contained disincentives for the public sector to walk away from the contract without paying significant compensation to both the lenders and the shareholders who have invested in the scheme. This was partly done in order to provide guarantees to investors in the scheme that they would receive a return on their investment in almost all circumstances. In doing so these contractual guarantees allowed those arranging the finance for PFI deals to keep the costs of private investment as low as possible.
8. As a result the public sector is effectively “locked in” to the PFI contract for the duration of the 25-35 year period even when the assets – such as schools or hospitals – are not needed or when paying the PFI operator becomes increasingly unaffordable at a time of austerity.
9. The disincentive for the public sector to exit from the contract works as follows. Most PFI contracts will include an option for the public body (known as the ‘Authority’) to terminate the contract early. However, two steps must be taken before termination can take place:
 - a) Compensation (a termination fee) must be paid to the PFI operator (the SPV) for ending the contract early. This is a contractual requirement.
 - b) The public authority must get approval from both their government department and the Treasury by demonstrating that terminating the PFI contract represents value for money for the public sector as a whole (and not just for the public body in question). This step is a non-contractual requirement.

a) Determining the compensation due to the PFI operator

10. The compensation to the PFI operator needs to leave them in roughly the same financial position as if they had continued the contract until the end. The elements that need to be compensated for by the public authority typically include:ⁱⁱ
 - The outstanding senior debt that the PFI operator owes to its lenders;
 - the breakage costs associated with ending any interest rate swaps, inflation swaps, or bond prepayment costs incurred by the PFI operator;
 - redundancy payments for employees of the sub-contractor(s) that will occur as a direct result of termination;

ii For more guidance on the terms of voluntary termination under a standard form PFI contract see Chapters 21.5 and 22 of HM Treasury (2007). *Standardisation of PFI Contracts Version 4*, May 2007. Available at: [https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/UK_Standardisation%20of%20PFI%20Contracts%20\(ver4.2007\).pdf](https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/UK_Standardisation%20of%20PFI%20Contracts%20(ver4.2007).pdf) (Accessed 16th July 2018).

- sub-contract breakage costs (i.e. contracts between the PFI operator and contractors who carry out services on its behalf);
- the corporation tax payable on any compensation received by the PFI operator; and
- compensation for either the base case value or open market value of contractor equity and junior debt (i.e. compensating the PFI shareholders).

11. The table below provides an estimate of the total termination fee that would be payable for eight hospital PFI contracts (excluding breakage costs relating to derivatives contracts, which are unknown, but are all likely to have a positive value), based on the annual accounts of the Trusts concerned. All but one of these Trusts are currently in financial deficit.

Table E1: Summary of costs of compensation for eight hospital trusts under voluntary termination

Costs £m	Barts Health NHS Trust	Central Manchester University Hospitals NHS FT	North Bristol NHS Trust	University Hospital of North Midlands NHS Trust	St Helens and Knowsley Teaching Hospitals NHS Trust	Sherwood Forest Hospitals NHS FT	Derby Teaching Hospitals NHS FT	Mid Yorkshire Hospitals NHS Trust
Repayment of debt	1,426.2	459.3	569.0	404.8	357.2	384.9	426.9	392.2
Market value of equity	74.0	61.0	98.0	16.0	35.0	34.0	48.0	29.0
Cash balance reduction	(3.2)	(73.6)	(1.0)	(10.0)	(1.6)	(1.5)	(12.2)	(25.2)
Transactions costs	4.0	2.5	2.5	2.0	1.5	0.5	0.5	2.0
Total subject to corp. tax	1,501	449.2	668.5	412.8	392.1	417.9	463.2	398.0
Corp. tax gross up at 19%	339.4	101.6	151.2	93.3	88.7	94.5	104.7	90.0
Total including corp. tax	1,840.4	550.8	819.7	506.1	480.8	512.4	567.9	488.0
Derivatives and bond redemption	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown
Total compensation	In excess of £1,840m	In excess of £551m	In excess of £820m	In excess of £506m	In excess of £481m	In excess of £512m	In excess of £568m	In excess of £488m
Surplus/(Deficit) in 2016/17 ⁱⁱ	(109.1)	(95.8)	(51.1)	(50.2)	15.5	(91.2)	(12.0)	(19.9)
Total compensation as a % of Total Income in 16/17	124%	51%	154%	68%	137%	173%	105%	97%

Source: Hellowell, Stapleton and Stafford, forthcoming

12. It can readily be seen that terminations are very costly and too large to be financed out of a trust's income. Even if funding were available to pay compensation to the PFI operator, the termination deal would have to demonstrate value for money for the public sector as a whole.

b) Determining the value for money of terminating for the public sector as a whole

13. Given the size of the compensation due it isn't clear that voluntarily terminating the PFI contracts represents value for money. The Treasury guidance on early termination requires a quantitative value-for-money assessment of the alternatives of terminating the contract and continuing.³ This comparison is between:
 - a) The cost of continuing the PFI contract. This is the present value of future PFI unitary payments until the end of the contract. The forecast tax paid by the contractor is deducted from the cost of the contract, because value for money is assessed from the standpoint of the public sector as a whole.
 - b) The cost of terminating the PFI contract. This is the sum of the termination/compensation cost (calculated above) and the future cost to the public authority of delivering the PFI services itself.

The value for money comparisons suggest a very limited benefit for many trusts

14. The Treasury guidance requires that the alternative scenario of buying out the PFI includes estimates for the future inflation costs of the trust in providing the services. These calculations are very sensitive to absolute and relative changes in forecast inflation rates (PFI contracts rise with RPI inflation, which is generally higher than the preferred government inflation measure of CPI). In the case of Hexham Hospital, the cost comparison showed a £14.3m benefit from terminating the contract versus continuing.⁴ This benefit could easily have been turned negative with changes in interest rate, inflation, or general cost assumptions. As a result it isn't guaranteed that termination will prove to be value for money, even for relatively expensive PFI contracts.

Obstacles to funding the termination fee

15. The cost of terminating must also include the method and cost of financing the termination payment. As illustrated in Table E1, for most trusts the size of compensation to be paid would be too large to fund out of their income, especially when many are running deficits. Instead they would either have to borrow the money or receive it as a grant from the Department of Health and Social Care.

16. In the case of the termination of the Hexham hospital PFI by Northumbria Healthcare Foundation Trust, the trust was able to borrow the termination fee from its Local Authority at 3.98% (fixed) interest.⁴ Given the financial pressure on Local Authorities in recent years this is unlikely to be replicable elsewhere.
17. The Department of Health and Social Care (DH) could provide funding via a loan or an equity-style investment (called 'Public Dividend Capital') at 3.5% interest. However, the Treasury guidance creates a strong disincentive for Departments to do so. Any funding for the termination provided by a Department is classified as part of their capital spending budget (known as 'CDEL') for the year, and these budgets are under pressure.
18. For example, the Department of Health and Social Care had only a £60m underspend against its entire capital budget (CDEL) of £4.6bn in 2016/17.⁵ If even the cheapest (£480.8m) of the PFI termination payments (from Table E1) was made with a grant, this would represent 10% of the total capital budget for the entire NHS and other DH functions for a year. The £60m underspend shows how tight the budgets are, and at the same time the NHS estate was estimated to have a backlog of £2.7bn (59% of CDEL) of significant and high risk maintenance in 2016/17.⁶
19. Without government approval for a larger capital budget there is no incentive for the DHSC to support a trust to voluntarily terminate their PFI agreement. Note that both Department and Treasury approvals are needed for a voluntary termination to proceed, and following Hexham hospital's PFI termination, DH civil servants worried that the termination could be repeated by other NHS bodies with 'unbudgeted financial consequences for the departmental and national accounts'.⁴
20. Additionally, the acquisition of the PFI asset would increase Public Sector Net Debt and Public Sector Net Borrowing, which would necessitate deeper cuts in other areas of government spending if government borrowing targets were to be maintained.

Conclusion on Voluntary Termination and buyout of PFI contracts

21. The costs of termination and the high bar set by the value for money comparison makes it unlikely that the voluntary termination of PFI contracts is a viable option for most hospital trusts. The Treasury guidance seems to agree, expecting the incidence of voluntary terminations to be 'low' and calling PFI contract termination a 'novel, contentious and potentially repercussive transaction'.³

Part 2: Termination of the PFI contract due to persistent failures or default events by the PFI operator

22. Aside from voluntary termination, PFI contracts include provisions for scenarios where the PFI operator consistently fails to deliver the standard of services required by the contract. In a 2017 survey of NHS trusts with PFI contracts, 16 of the 81 respondents (20%) stated that they had reached a point in the last three years where they had the right to terminate their contract.²
23. The reason for reaching this point was generally the accumulation of enough serious ‘service failure points’ (SFPs), often due to serious building defects or fire safety issues. An example of this, from one of the sixteen trusts, is Tees, Esk & Wear Valleys NHS Foundation Trust, which in July 2018 was granted the right to terminate its PFI agreement.⁷
24. However the NHSI survey identified that another NHS Trust in the same position decided not to terminate their contract. Instead the trust used the threat of termination as a ‘lever’ to negotiate and remove the cleaning and facilities maintenances services from the scope of the contract with the PFI company. It was then able to re-tender this service and contracted with an alternative company to provide the same services but at a lower cost. The NHS Trust estimates that in doing so it has saved £8m over the remainder of its PFI contract.²
25. This section looks at what happens once an NHS Trust has the right to terminate a PFI contract due to persistent breaches by the PFI contractor. It shows why other NHS Trusts in this position may also decide to not terminate their contract and instead renegotiate services with the PFI operator, as in the second example above.^{iii iv}

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iii To guide us on the approach and steps of this type of termination under a standard form PFI contract we have used see Chapter 21 (and others) of HM Treasury (2007). *Standardisation of PFI Contracts Version 4*, May 2007. Available at: [https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/UK_Standardisation%20of%20PFI%20Contracts%20\(ver4.2007\).pdf](https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/UK_Standardisation%20of%20PFI%20Contracts%20(ver4.2007).pdf) (Accessed 16th July 2018).

We have also referred to Department of Health and Social Care (2007). *Department of Health Standard Form Project Agreement Version 3*, March 2007. Available at: http://webarchive.nationalarchives.gov.uk/+/http://www.dh.gov.uk/en/Aboutus/Procurementandproposals/Publicprivatepartnership/Privatefinanceinitiative/InvestmentGuidanceRouteMap/DH_4132871 (Accessed: 16th July 2018).

iv Not all PFI contracts signed are Standard Form (SF) and this may affect some of the steps or consequences of termination. Thirty-one of the 81 trusts held SF contracts for all their PFI agreements, 12 had SF contracts on some of their agreements, leaving 38 which either did not have SF contracts or which answered that they weren’t sure.

What is a persistent breach and what needs to be done before commencing termination?

26. In order to incentivise the PFI contractor to adhere to the standards set in the contract, performance points or ‘service failure points’ (SFPs) can be awarded to penalise the provision of sub-standard services.^v These points can lead to reductions in the annual unitary payment paid to the PFI operator in order to encourage them to improve their services. However, this could lead to situations where minor breaches occur persistently and are not fixed because they are not large enough in themselves to lower the unitary payment significantly.
27. Another scenario is when there are large and persistent service failures which are not being rectified. In both cases, if a threshold number of performance points or SFPs are levied, and these continue over a contractually agreed period of time without being rectified by the PFI contractor, the trust will have the right to terminate the contract.
28. In the case of Tees Esk & Wear Valleys NHS Foundation Trust the contract stated that a ‘Project Co Events of Default’ was triggered if the SPV was awarded 8,593 or more SFPs in any rolling 6-month period. If this happened, then the awarding of a further 4,297 SFPs in the following three-month period would allow the Trust to terminate the PFI agreement in writing immediately. In this case 56,144 SFPs were awarded in May 2016 and within three months (in August) a further unrelated 1,657,946 SFPs were awarded, allowing the Trust to terminate the agreement.⁷
29. However, termination is considered the least desirable option. As a result, before termination becomes an option the standard contract gives the lenders to the PFI operator the right to ‘step-in’ to try to rectify the breaches, or transfer the contract to another PFI operator. These terms are often included in a ‘funders direct agreement’ (FDA) between the trust and the lenders to the PFI operator.
30. In the Tees, Esk & Wear Valleys NHS Trust case the PFI operator’s main lender (the Bank of Scotland Plc) was trying to prevent the PFI agreement being terminated, arguing that the Trust hadn’t correctly notified it of the right to terminate the PFI project as per their agreement (FDA). The Trust challenged this and won the right to terminate.⁷

What compensation is due for termination for breach?

31. Even with a persistent breach by the PFI operator, the contracts require a ‘market value’ level of compensation to be paid to the outgoing PFI operator. This is unlike a standard services contract, where no compensation is paid to the sub-standard supplier, and damages may even be due.

^v These are usually awarded in agreement with the PFI company or, if disputed, by an adjudicator.

32. The logic behind this argument is that without some form of compensation as a result of terminating the agreement early the trust would be gifted the new hospital or school without paying the full value for it.
33. Market value is chosen as the approach for calculating compensation because it is argued that it gives the senior lenders to the PFI operator an incentive to try and rescue the PFI project. They can do this through carrying out remedial works or finding a new PFI operator for the contract themselves. The fact that the lenders would only receive compensation at the “market value” of the asset provides an incentive for the lenders to the project to rescue the project, as otherwise there is a risk that they may not receive back the full amount lent.
34. The two approaches for determining the compensation payments in the PFI contract are:
 1. To retender the PFI contract (the preferred approach).
 2. If retendering is not possible then the trust will pay the PFI operator itself.

1. Retendering the contract

35. If there is a liquid market for PFI contracts then the trust can choose to retender the remaining length of the contract. In general, a liquid market requires at least two suitably qualified entities that could bid on the contract. The assumption is that through competitive bidding the ‘market value’ of the contract (i.e. the compensation due to the outgoing PFI operator) will be found. If there are no bids (in a liquid market) then the contract value is assumed to be zero (or negative).
36. The contract offered for tender is expected to be the same as the original PFI agreement in terms of services provided and unitary payments due. The idea is to make the trust no worse or better off (minus the costs of disruption) than if the original PFI operator had completed the whole contract. The possibility of buying into a PFI contract with reliable cash flows without the risk of building is designed to entice bidders. The desirability of these investments is evidenced from the high sales prices achieved when investors sell their stakes to each other.⁸
37. In addition, during the period between the termination date and the start of the new contract the outgoing PFI operator is still due payments from the trust to help support its debt repayments. These payments equal the unitary payment net of deductions made for rectification costs and the cost of providing services in-house by the trust (following termination).
38. Once the bids are submitted the trust can choose the bid which represents the best value for it. However, the outgoing PFI operator must be paid the highest price bid, net of any costs of retendering and service provision by the trust (known as the ‘Adjusted Highest Compliant Tender Price’), even if the trust chooses a lower priced bidder. So, using this method the compensation

paid to the outgoing PFI operator is the Adjusted Highest Compliant Tender Price. Indeed, the standard form contract states that the ‘objective’ of retendering is to secure the highest price for the outgoing PFI operator (who, it should be noted, provided a persistently sub-standard service).

39. In terms of payment timings, even if the new bidder agrees to pay the purchase price over time, the trust is obliged to pay the full amount up-front to the outgoing PFI operator, although whether this would be enforced in reality by the outgoing SPV is uncertain.

2. No retendering

40. When there is no liquid market, or the services required have radically changed for other operational reasons, the trust can choose to not retender the remaining term of the PFI contract. In this case the trust has to pay the outgoing PFI operator from its own resources the ‘market value’ it would have received if an appropriate tender process had been carried out.
41. To calculate the ‘market value’ an estimated fair value calculation is used, which looks at the cash flows from the remaining term of the PFI project and estimates how they would be valued by a bidder using the original financial model. It also includes consideration of the breakage costs on interest rate swaps, so that the outgoing PFI operator is partially or fully compensated for these. This calculation is done by the trust, with the outgoing PFI operator’s input.

Conclusion on termination due to breaches/default by the PFI operator

42. The Standard Form PFI contract tries to make termination a last resort. For trusts which feel that their PFI contract is bad value for money, the right to terminate does not offer an escape from the contract unless they are willing to pay a price up-front to exit the contract without re-tendering the services.
43. Against the backdrop of financial difficulties in the outsourcing market, and nervousness amongst infrastructure investors over the future of PFI projects, it does not seem certain that a liquid market will always exist.^{9 10} In this case the only option available to trusts is to buy out the PFI contract up-front at an estimated market price.
44. Given the financial difficulties facing NHS hospital trusts, and limited financial headroom at the DH, it seems unlikely that many trusts could afford to pay for such a termination. With this in mind the decision by the NHS Trust cited in the NHSI survey not to terminate but instead to keep their contract and renegotiate the soft-FM services looks like a rational decision, based on the constrained choices (financial and otherwise) that they would have faced if they had chosen to terminate the contract.

Analysis of Terminate or buy out the PFI contracts

Advantages

- 45. In the case of voluntary termination – through a buyout – and termination without retendering the trust gets to leave the PFI contract entirely and in-source the services provided. This will improve the value for money of the services provided, as they can save on the PFI operator's profit margin.
- 46. In the case of termination by retendering the trust is hopefully given the opportunity to get an improved level of service (from a new PFI operator) without having to incur any significant additional costs (with the bid paying all or most of the compensation due).

Disadvantages

- 47. For those who consider their PFI contracts to be inherently poor value for money, the high costs of terminating (voluntarily or in the case of breach/default by the PFI operator) will appear to be adding insult to injury.

Feasibility

- 48. Both solutions are contractually possible and have occurred recently in the NHS. In general, given the constraints imposed on trust finances, departmental budgets, and Treasury rules for approval, it is unlikely that many trusts are in a position where they could afford to terminate their PFI contract, even when the PFI operator has been at fault.
- 49. Recent policy announcements, and changes in the PFI investors' and contractors' markets, also reduce the likelihood of a liquid market existing, which would be the alternative way to terminate when a PFI operator is at fault.

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Option 5: Nationalise the PFI operating company (the SPV)

Introduction

1. This chapter looks at the most radical of all the options for dealing with the legacy of PFI, namely nationalisation of the companies which have been set up to finance, build, run, and oversee PFI contracts. These companies are the Special Purpose Vehicles (SPVs) which were established for each of the PFI contracts. The nationalisation of these companies would be unique in the UK's history of nationalising private companies.
2. This option has been developed in detail by Helen Mercer and Dexter Whitfield and we set out here the key elements of their proposal based on their recently published paper.ⁱ We also discuss the advantages, disadvantages, and feasibility of the proposal.
3. In summary, the option discussed here proposes using primary legislation, in the form of an Act of Parliament, to take the PFI companies (the SPVs) into direct public ownership by purchasing all of the shares in these companies. This would mean that the PFI companies would not be able to extract the sizable profits from PFI schemes which we have previously identified, thus immediately saving an estimated £1.4bn a year.
4. The government would then use its ownership of these companies to require various substantive changes to be made to existing PFI contracts. Importantly, the process of nationalisation would not directly lead to a large reduction in the high debt costs of PFI. These costs are primarily the result of the high interest rates attached to the loans used to fund the building of the new school or hospital. These loans amount to 90% or more of the total financing of PFI schemes and are borrowed by the SPVs upfront. The duty to repay these loans at the rate of interest agreed between the lenders and the SPVs would transfer from the SPV to the public sector upon nationalisation.
5. However, it is argued that ownership of the PFI companies by the state would put the government in a strong position to lower the interest rates on these loans by requiring the lenders to re-finance the debt, thus making it cheaper for the public sector. Ownership of the PFI companies would allow a change in the service contracts (e.g. for cleaning or maintenance) so that they are directly accountable to the relevant public body.

i This solution paper summarises key elements of the proposal of Helen Mercer and Dexter Whitfield. For more details on their proposal see: Mercer, H. and Whitfield, D. (2018) *Nationalising Special Purpose Vehicles to end PFI: a discussion of the costs and benefits*, PSIRU Working Paper. Available at: http://gala.gre.ac.uk/20016/1/20016%20MERCER_Nationalising_Special_Purpose_Vehicles_to_End_PFI%20_2018.pdf (Accessed 31st July 2018).

The historical precedent for state nationalisation of privately owned companies

6. Historically nationalisation has been used by governments to correct market failures, ensure national security, to serve industrial strategy, or generally to promote the public good. Examples include:
 - Correcting the market failure of a private monopoly, e.g. railways, canals, gas and electricity.
 - To protect national security or strategic sectors such as coal, iron, Rolls Royce.
 - To provide public goods, e.g. healthcare, education, water, and housing.
7. Individual PFI SPVs differ from these examples in that they own an 'intangible' asset, namely the income and associated profits promised by a public body for the provision of a service, e.g. the building of a hospital and the maintenance of the hospital over the life of the PFI contract.
8. They are called Special Purpose Vehicles because they were specifically set up in relation to each individual PFI contract with the public sector. These SPVs then often sub-contract work to construction companies to build the hospital and to facilities maintenance companies to clean and maintain the hospital over a 25-35 year period. Sometimes they sub-contract the work to the parent company itself (which is why the investors in PFI schemes are sometimes also responsible for building the new hospital).
9. SPVs generally do not have any employees themselves to deliver PFI services, but instead have a small number of employees to receive income from the public authority, administer the payment of loans, and hold contracts with subcontractors. The parent companies of the SPVs – for example Carillion and Innisfree – are the main shareholders in these companies, although it should be noted that often a single SPV may have a number of different shareholders.
10. As a result the value which can be attributed to such companies does not lie in the value of a 'tangible' asset such as the actual NHS PFI hospital – whose ownership reverts to the public at the end of the contract – but the income stream which the contract with the NHS Trust generates over a 25-35 year period. This income stream from the public sector is used by the SPVs to repay any loans that they have raised to pay for the cost of building and maintaining the hospital. Anything which is left over is their profit.
11. In a similar way, the debt which lies behind the PFI contract is owed to banks and other investment funds and its value is dependent on the guarantees provided by government that the PFI repayments will be repaid. These loans will need to be repaid even in the event that the SPV and its parent company are unable to operate, as was the case when Carillion went into liquidation.

12. If the government chose to nationalise PFI SPVs it would not be expropriating a physical asset (i.e. ‘tangible asset’) in the same way that occurred when the railways were nationalised. However, it could be argued that nationalisation is nonetheless justifiable on the grounds that there is a public interest in correcting the unfair nature of PFI contracts. This is because these contracts have led to financial distress for public bodies, excessive profits for the PFI operators, poor value for money, tax avoidance by the SPV owners, and poorer terms of employment for staff providing the outsourced public services.

The process of nationalisation

13. An Act of Parliament would be needed to nationalise the SPVs. Under the proposal set out by Mercer and Whitfield the shares owned by the SPVs’ investors would be expropriated and vested in a newly created government body, either a Non-Departmental Public Body (NDPB) or a government-owned company.
14. This new body would then have two primary responsibilities. First, to renegotiate the service contracts so that they are between the public body and service contractors directly. Currently in PFI deals the service contracts are between the SPV and contractors, with a separate agreement between the SPV and public body.
15. Second, the new body would be charged with refinancing the outstanding debts and liabilities which are owed to the banks and other investment funds.
16. With regard to the scale of nationalisation there are three options:
 - Nationalise SPVs individually in specific cases where there are significant issues.
 - Nationalise SPVs in specific areas of public services e.g. roads, waste management.
 - Nationalise all SPVs which hold PFI contracts.

The legality of the nationalisation of SPVs

17. The authors propose compensating the SPVs’ shareholders for nationalising their companies, however the level of compensation is likely to be a contentious issue. Due to the controversial nature of this proposal and the fact that it is likely to be opposed by the shareholders involved, there could be a challenge to the legality of such a proposal in the UK and European courts.

18. The justification on legal grounds which has been put forward by Mercer and Whitfield is that Parliament has the power to transfer property ownership and decide in each case the compensation due. On their view, under UK and EU law there is no requirement to compensate at market value. Judicial reviews can challenge the process of nationalisation and the compensation but the courts cannot overturn primary legislation which expropriates shares. In the cases of Northern Rock and the shipbuilding and aerospace companies, for example, the Court of Appeal upheld decisions by the UK government to compensate shareholders at less than ‘market value’.
19. The European Court of Human Rights (ECHR) in both cases decided that legitimate objectives such as ‘public interest’ or achieving ‘greater social justice’ may lead to cases of compensation at less than full market value, and that it would ‘substantially defer’ to national governments on making such judgements. If the Act of Parliament was found to be incompatible with the European Convention on Human Rights then the ECHR could issue a declaration of incompatibility but not overturn the legislation.ⁱⁱ
20. It should be noted that this interpretation of the legality of nationalisation, and the compensation which would need to be paid to the shareholders of SPV, is different from that which other legal analysts have put forward.ⁱⁱⁱ
21. They argue that Article 1 of the European Convention on Human Rights – incorporated into UK law by the Human Rights Act 1998 – guarantees the rights to the peaceful enjoyment of property. Whilst the courts cannot strike down an Act of Parliament, if government is found to be acting in a way which is not compatible with the ECHR they can issue a declaration of incompatibility which would allow companies which objected to nationalisation to seek redress through the courts. If the proposed nationalisation does not provide fair compensation an objection could be raised.
22. A further constraint which has been identified is the existence of Bilateral Investment Treaties (BIT) which are designed to facilitate investment by private companies between the countries which are party to the Treaty. A company which is based in a country that is party to a BIT could have potential redress under a BIT if they are unhappy with the level of compensation that they would receive under any proposed nationalisation. The standard BIT agreements require that “[s]uch compensation shall

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ii For more discussion on the legal aspects see: Mercer, H. and Whitfield, D. (2018) *Nationalising Special Purpose Vehicles to end PFI: a discussion of the costs and benefits*, PSIRU Working Paper. Available at: http://gala.gre.ac.uk/20016/1/20016%20MERCER_Nationalising_Special_Purpose_Vehicles_to_End_PFI%20_2018.pdf (Accessed 31st July 2018).

iii For a detailed discussion of the possible legal restraints facing any nationalisation proposals, including on PFI see this report by the Law Firm Clifford Chance, *UK Nationalisation: the law and the cost*, Clifford Chance, March 2018. Available at: https://financialmarketstoolkit.cliffordchance.com/content/micro-facm/en/financial-markets-resources/resources-by-type/thought-leadership-pieces/uk-nationalisation---the-law-and-the-cost--march-2018-/jcr_content/parsys/download/file.res/UK_nationalisation___The_law_and_the_cost.pdf

amount to the genuine value of the investment expropriated”.^{iv} This could potentially provide foreign investors in PFI with an additional route to challenge the terms of any nationalisation through the arbitration process attached to such Treaties.

Providing compensation to the owners of the SPVs

23. Under this proposal, Mercer and Whitfield consider that it is necessary to override the compensation requirements for the voluntary termination of PFI deals which are set out in the PFI contracts. As noted elsewhere in this report (see Chapter 4), this compensation should not leave the investors in the PFI contract in any worse financial state than if the contract had not been terminated. If this level of compensation was paid it would almost certainly not represent value for money.
24. As a result an Act of Parliament would need to set out an approach to calculating the appropriate level of compensation due, which overrides the existing contract provisions. Consideration needs to be given to how this compensation would be calculated.
25. As noted above, nationalisation has traditionally involved the state expropriating the ‘tangible’ assets of a private company which the government will then own and be able to exploit. In the UK, the traditional approach has been to compensate for expropriating these assets at their ‘market value’. Market value is set at the price that would have been paid if a sale had occurred between a willing buyer and seller.
26. However there have been some notable exceptions to this. For example, Northern Rock was nationalised in 2008 and no compensation was paid. Shipbuilding and aerospace companies were nationalised in 1977 and compensation was calculated according to the average of the quoted share price over the prior six months and not ‘market value’.
27. Mercer and Whitfield consider the market value approach inappropriate in this case because:
 - SPVs’ shares are not listed, so there is no easy way of establishing a price for them.
 - For some the market value could be established from looking at past sales of shares in SPVs. However the prices paid in these sales will reflect the expectation of the continuation of high contract profitability. As this proposal is intended to tackle the excessive profitability of PFI contracts they consider it counter-productive to compensate at these levels.
28. As an alternative to the market value, ‘book value’ is proposed as a more appropriate level of compensation. Book value is the difference between

iv Clifford Chance (2018), p9

a company's assets and liabilities as per their accounts and is also known as 'shareholder equity'. This approach is considered more appropriate by Mercer and Whitfield because:

- It is widely used internationally as a form of compensation for expropriations.
- It is considered an accurate measure of the value of the shareholders' ownership at a point in time without including future earnings (which are included in the market value approach).

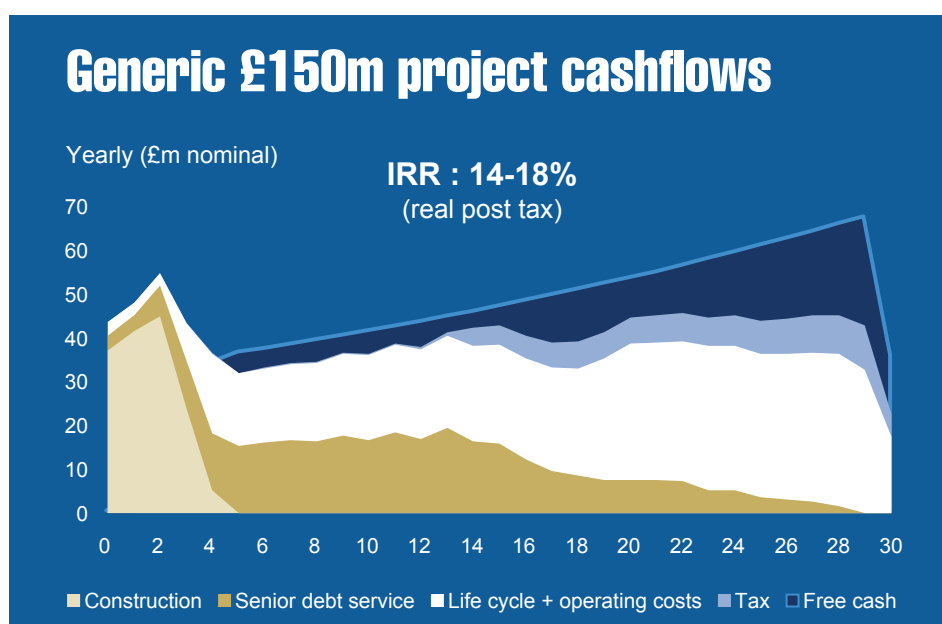
The proposed level of compensation

29. To estimate the level of compensation which might be due to the owners of SPVs under this approach, Mercer and Whitfield examined a sample of 100 SPVs (out of a total of approximately 699 SPVs) with existing PFI contracts. This sample was reasonably proportionate to the different sectors, locations, capital values, and dates of financial close of the SPV population.
30. Of the 100 in the sample, 42 SPVs had a positive book value, totalling £373.2m, while the remaining 58 had a negative book value (their assets were less than their liabilities) totalling £801.0m. If this is representative of all 699 SPVs, then 294 SPVs will have a total book value of approximately £2,612m, whilst 405 SPVs will have a total negative book value of £5,593m.
31. The shares of the 405 SPVs with negative book values would be purchased at £1.00 each and the 294 SPVs whose book value is currently £2.6bn would be purchased at that existing price. Because in a small number of PFI schemes the public body owns shares in PFI companies – estimated to be 1.9% of all the shares in PFI companies – the government would not need to also purchase these and so these can be deducted from the total cost of purchasing the shares.
32. In total, this leaves an estimated final compensation payment of around £2.5bn for the shareholders of PFI SPVs. This would be paid for by issuing government bonds and Mercer and Whitfield estimate that this would represent an increase of 0.14% in the UK national debt of £1.78tn (at March 2018).
33. However, it should be noted that there are likely to be arguments put forward about the size of this compensation package. In particular, the affordability and attractiveness of this proposal rests on assumptions about how the value of SPVs is calculated at the point of nationalisation. One particular aspect of Mercer and Whitfield's proposal which requires further consideration is their assertion that a large number of SPVs – i.e. the 405 with negative book values – are 'effectively bankrupt'.^v

v Mercer and Whitfield (2018), p33

34. The reason why so many SPVs have a negative book values is not because they are not profitable or not likely to be profitable. It is instead because of the accounting measurement of their 'interest rate swaps'. These swaps are contracts to pay a fixed interest rate on their debt, to insure against possible changes in interest rates between when the contract was signed and the fluctuations of interest rates throughout the course of the contract.
35. As current interest rates are historically low (and are much lower than when most of the deals were signed) the SPVs are in effect paying over the odds via these swap contracts to have a fixed interest rate on their debt which is higher than is currently available. Because these swaps are recorded in the accounts as assets – which other investors could choose to buy on the open market – i.e. their 'fair value' – they currently have little value (no one would currently want to buy into these deals) and so in the accounts are measured at their current negative value.
36. But the fair value of a swap will fall to zero when the contract ends – in a sense the insurance payment will have been made and the payments will cease – and so it does not affect the financial viability of the SPV, as it will hold the swap until the end of the contract.
37. By excluding the negative value of the swap most of these SPVs would have a positive book value and hence if compensation was paid at 'book value' it would be significantly higher than that estimated by Mercer and Whitfield.
38. In addition, it could also be argued that the value of an income stream such as that which is attached to a PFI contract needs to be considered over the full life time of the contract rather than a fixed point in time. Thus, it is the case that at the beginning of a PFI contract SPVs have a fixed income but high outgoings in the form of capital repayment on the debt, the interest on the debt, and the cost of building the hospital. In the early stages of the contract it is often the case that SPVs will make a loss.
39. However, towards the latter years of the contract – after the hospital has been built and significant parts of the debt have been repaid a greater proportion of the income (which comes from the public sector) will be available for profit for shareholders.

Figure F1. Balfour Beatty projection of cash flows from the lifetime of a PFI project.^{vi}



Source: Balfour Beatty, PPP/PFI Seminar. London, June 2003.^{vii}

40. As a result a company which looks unprofitable at one point in time may turn a significant profit in the future. So it is likely that the SPVs' shareholders would seek compensation for this future loss of earnings in any nationalisation legislation.

Table F1: Estimated level of compensation paid for nationalisation and adjustments

Category of PFI equity ownership	% of total PFI equity held	Option A share of shareholder equity in 294 SPVs (£m)	Option B Cost of each 10% variation (£m)	Option C 42% of £600m offshore tax loss (£m)
Offshore infrastructure funds	51.3	1,340	-134	-252
Other private ownership	42.1	1,100		
Pension funds	4.7	122	+12	+25
Public sector	1.9			
Deduction from total cost of compensation			-121	-227
Total	100	2,562	2,437	2,331

Source: Mercer. H, Whitfield, D. (2018)

^{vi} This excludes the higher returns available to PFI investors who sell their equity stake early i.e. before the project ends.

^{vii} Available at: https://www.balfourbeatty.com/media/29335/ppp_pfi_2003.pdf

41. Table F1 sets out the level of compensation based on a number of different options. Option A is the compensation based upon the estimated book value of all 699 SPVs with operational PFI schemes.
42. Option B takes into account an adjustment for the fact that a significant amount of taxation is lost due to the offshore location of the major shareholders that are infrastructure funds. It proposes that for every 10% taken off the compensation due to these offshore investors (to compensate for lost taxation over their years of ownership) an extra 10% is given to the pension funds that have directly invested in PFI SPVs.
43. Option C reduces the amount payable to the infrastructure funds by the size of the estimated £600m tax receipts lost as a result of the fund being located in offshore tax havens.¹ Some of the amount saved could then be used to help with any losses to pension funds.

Post-nationalisation PFI contract changes

44. By itself the purchase of the SPV equity by the government does not address the high cost of PFI debt and it also pays out to the parent companies of PFI schemes companies a return on their investment through the compensation payment. However, this solution achieves savings and works towards the public interest through what happens once the government owns the SPVs, and hence has the power to change and renegotiate the contracts. At the point of nationalisation, the government will have incurred direct costs of £2.6bn plus any costs involved in setting up the national body to administer the newly nationalised SPVs. In order to make back these costs and achieve additional savings, the following steps are proposed:
 - The public authority with a contract with an SPV would continue to pay to the (now government-owned) SPV that element of the unitary payment which covered the interest and repayment of principal on the SPV's debt.
 - The SPV would honour all outstanding debts. No agreement with banks or bondholders would be broken, but the new government body would seek substantial refinancing, especially of shareholder loans, in order to reduce interest payments: lenders would effectively be asked to write-off part of the original debt. A suitable resulting rate of interest on the remaining debt would be that at which local authorities can borrow, either from the Municipal Bonds Agency or from the Public Works Loan Board (2.5%). Such refinancing could reduce interest on senior (bank) debt by 50% and on subordinate (shareholder) debt by 75%.
 - Interest rate swaps. The NAO estimates that collectively the net position on swaps in SPV accounts is £-5.8bn, but suspects the figure could exceed £-6bn.

45. There are three possible options to deal with interest rate swaps:

Option A: All swaps are broken and breakage fees paid to the extent that cash balances on the accounts of SPVs allow (the NAO estimates that SPVs collectively had £4.4bn in cash held at the year-end of 2014). In this case additional costs to the Treasury are avoided.

Option B: All swaps are broken but no breakage fees are paid. This represents default, but could be justified given that (a) the setting of the premium on the senior debt interest rate was opaque; (b) such contracts were signed under a form of duress (public bodies had little choice but to agree to PFI contracts with swaps as they were insisted upon by PFI operators and the Treasury wouldn't offer protection against interest rate changes); and (c) given the low rates of interest since 2008 the counterparties to the swaps have made very significant gains.

Option C: Swaps are not broken but renegotiated as part of the refinancing of the senior debt.

Existing construction and service contracts after nationalisation

- 46.** The SPVs hold contracts with companies to deliver the cleaning and facilities maintenance for the hospital for the lifetime of the PFI contract. Mercer and Whitfield propose that following nationalisation these contracts would be transferred to the relevant public authority (e.g. the NHS trust) so that all continuing service contracts for facilities management and cleaning would be directly between the service contractors and the public authority. The public authority would pay the private company directly, according to the payments agreed in the original contract between the contractors and the SPV.
- 47.** Under existing PFI contracts, the SPV is able to make a profit through paying the sub-contractors for the provision of services less than what it receives from the NHS for providing these services. In this way they make an extra profit by forcing down the costs of service provision by cleaning and facilities maintenance companies.
- 48.** Under the Mercer and Whitfield proposal there would not be any of this 'leakage' of NHS funds away from the public sector as the service providers would be paid directly at the cost that they charge for delivering the service. This would generate savings to the public body. A sample of 100 SPV annual reports and accounts for 2016 and 2017 undertaken by Mercer and Whitfield identified total annual operating profits of an estimated £204.7m, which extrapolates into £1.4bn per annum based on 699 SPVs. These profits would no longer be needed and would therefore represent savings to the public authorities.¹

49. Mercer and Whitfield propose that the nationalisation Act should stipulate that as service contracts are ended, either at break clauses (provisions in the contract which allow it to be ended at a specific point in time) or because of poor performance, the services will be provided in the future directly by the public authority. Ending the outsourcing of services that are part of PFI contracts is a major aim of their proposal. A further option is to stipulate in the Act, or a supplementary Act, levels of service provision, rates of pay, and working conditions under which all outsourced public contracts must operate. This could have the effect of encouraging contractors to seek to end the contracts themselves on the basis that they are no longer profitable.

Analysis of Nationalising the SPVs

Advantages

50. This solution is intended as a comprehensive solution to the legacy of PFI. If successfully implemented it would tackle head on the unwelcome costs of PFI, namely the excessive profits made by the shareholders of SPVs and also the high costs of borrowing.
51. It would also gradually free the public sector from 25-35 year long contracts for outsourced services, which are inflexible and difficult to monitor and enforce. The employment status of those workers who currently provide these services in NHS hospitals would significantly improve as, over time, they would be transferred back into public sector employment. This would have additional economic and social benefits.
52. Whilst this proposal does require substantial compensation payments to be made to the shareholders involved in PFI – estimated here to be in the region of £2.6bn – this cost would be recouped in under two years based on the estimated annual saving of £1.4bn from eliminating the SPVs' operating profit margins. Furthermore, if this payment allows the public sector to re-finance the debts attached to PFI schemes by a significant amount it will lead to lower costs to the public sector and alleviate the financial burden placed on local authorities and the NHS by PFI. This would in turn make more funds available for the NHS and other public services.

Disadvantages

53. The initial value for money of this option depends upon the level of compensation paid. If it is restricted to £2.6bn then this outlay will be recouped in under two years. However, given the estimated profitability of the SPVs, making £1.4bn of operating profits a year, it is unlikely that their owners will accept such a low offer. It is unclear how much larger the final compensation payment would be as it depends upon legal considerations.

54. In addition to the cost of compensating the shareholders there is the outstanding issue of the interest rate swaps. As mentioned earlier it is estimated that the cost of breaking these swaps is £6bn. So if these were paid in full, the overall level of compensation paid would rise to £8.6bn, which could be partly offset by the SPVs' cash balances. This option looks at three ways to handle these swaps which involve partial to no compensation. It is likely that the holders of these swaps would seek legal redress for any underpayment for breaking the swaps. This is another area of uncertainty and any increase in these costs of compensation reduce the overall value for money of the option.
55. Refinancing the SPVs' loans would lead to substantial further savings. Officially loans make up 90% of the overall investment in PFI deals, but much of the shareholders' investment is through loans too, so in total loans can equate to 99% of the overall investment. Upon nationalisation the responsibility for paying these high interest loans will fall upon the public sector owners. As this option has never been implemented before it is unclear whether the lenders (such as banks and other investment funds) would be willing to lower the cost of finance to the public sector through re-financing the loans without a further Act of Parliament requiring them to do so.
56. One possible reason why this might not be the case is that if the public sector bodies were to take on full responsibility for making repayments the lenders would be guaranteed that the repayments would be made (as they would be backed by government) and so they would see them as highly favourable loans which they would have no incentive to re-negotiate. They would be receiving interest payments far higher than they could achieve if they had bought government bonds.
57. Or put another way, banks are often willing to re-negotiate loans when there is a substantial risk of them not being paid back the full amount – for example when a company is in severe financial difficulty – but not when they are guaranteed to receive a high rate of interest from the risk-free public sector.
58. If refinancing does not take place immediately, or at all, then the initial and subsequent 'profit' available to offset the cost of compensation will be lower than the £1.4bn of operating profits a year. This because after taking into account the costs of administration and paying for contractors (used to calculate operating profit), there is additional yearly interest income and the costs of paying the SPVs' debts (summing these together results in a 'net interest' figure). After taking these into account the 'profit' available to the public sector is Profit Before Taxation (PBT). To illustrate how this would affect the annual profits returned to the public sector we will use accounts data covering 2010-2015 for 107 SPVs which have Health PFI schemes.^{viii}

viii This is an estimate based on 6 years of data for one sector (health), representing around 15% of all SPVs. Any complementary analysis of the 100 SPVs covered by Mercer and Whitfield would improve the robustness of these estimates.

Table F2: Profitability of 107 PFI SPVs over 6 years (2010-2015) and estimated profitability for all 699 SPVs per year

	Turnover	Operating Profit	Net interest ^{ix}	Profit Before Tax (PBT) ^x	Tax charge	Profits After Tax
Six-year total (2010-2015)	£9,736m	£972m	-£172m	£831m	£151m	£680m
Estimate for all 699 SPVs per year	£10,601m	£1,059m	-£187m	£904m	£164m	£740m

Source: Review of SPV accounts held at Companies House, FAME

59. Assuming that any taxation levied is returned to the relevant public authorities leaves an estimated initial saving of £904m a year to offset against the cost of compensation. If the tax collected is not returned then this falls to £740m (compared to the proposed £1.4bn estimate of annual savings). This is a sizable annual saving but alters how quickly the initial compensation costs will be recouped. However, as noted below in the footnotes ‘profit’ is not the same as actual cash available so care must be taken when estimating the amount that will be actually available to the public sector each year.
60. Aside from uncertainty over the size of compensation and the annual savings, it is not known what the size or likelihood of any unintended consequences could be. Nationalisation and compensation at less than full value could alter the terms of engagement between government and the private sector (including both investors and lenders). Private sector contractors may in future contracts (beyond PFI) demand higher upfront payments or shorter terms to insulate themselves against the risk of expropriation. This may in sum, and over time, negate any gains from nationalising the SPVs. Alternatively, it may lead to contracts which reflect a more socially acceptable profit margin for private companies. At the extreme, if lenders lost confidence in the UK government’s willingness to honour its debts fully, an increase of 1% in UK gilt (government fixed-interest bonds) and short-term borrowing rates would increase the government’s overall debt interest and repayments by £5-9bn a year, which could negate any financial gains made by this proposal. Due to the financial crisis in 2008, over a third of UK gilts are currently owned by the Bank of England so any further purchases by the Bank could limit the financial impact as it is effectively one arm of government lending to another. However the use of these intra-government purchases is expected to have ended and they are likely to now be gradually reversed.²

ix Part of Net interest will be related to movements in financial instruments and some of the income and expenses made to calculate profit are non-cash accounting adjustments. As such caution should be exercised when equating ‘profit’ with cash available i.e. profit is a rough proxy for cash available at year-end but can in some cases be very different in absolute size or time profile (when it’s received).

x There are other adjustments that can be made before reaching PBT hence why the PBT is not exactly the same as the sum of Operating Profit and Net interest.

Feasibility

61. The ambitious and potentially controversial nature of this proposal would require the political will in Parliament for an Act of Parliament to nationalise PFI companies. The level of compensation would be a significant issue as would the potential knock-on consequences for the wider economy and for government borrowing. It is likely that any government which attempted to introduce such a scheme would need to have a large majority in the House of Commons and would need to present a robust case justifying the costs and benefits of such a proposal.
62. It is also highly likely that this proposal would be challenged in the courts, both domestically and internationally, using some of the grounds outlined above. It is unclear whether any legal challenge would be successful but it should be noted that international law, including human rights law and also laws relating to investment treaties, is designed to limit national governments' ability to expropriate private assets without providing adequate compensation. As a result, successful implementation of this proposal would require a significant commitment to dealing with the potential political and legal obstacles.
63. That said, as with all of the options presented here, the possibility that a government may in future enact the nationalisation of SPVs could provide a strong incentive for the shareholders of these companies to re-negotiate their contracts. This could result in PFI companies offering up savings to public authorities through refinancing and contract renegotiation in order to avoid the state expropriating their assets.

References

- 1 Mercer, H. and Whitfield, D. (2018) *Nationalising Special Purpose Vehicles to end PFI: a discussion of the costs and benefits*, PSIRU Working Paper. Available at: http://gala.gre.ac.uk/20016/1/20016%20MERCER_Nationalising_Special_Purpose_Vehicles_to_End_PFI%20_2018.pdf (Accessed: 31st July 2018).
- 2 Office for Budget Responsibility (2017) *The outlook for debt interest spending*. Available at: <http://obr.uk/the-outlook-for-debt-interest-spending/> (Accessed: 2nd August 2018).

Annex 1: Summary of the Options

Solution	Objection(s) addressed			Solution steps	Findings and Outcomes	Advantages	Disadvantages	Feasibility
	Financial burden of PFI	Poor value for money/ excess profit making	Outsourcing of services					
Improve the contract performance and management of PFI schemes.		✓		Pool PFI contract management and expertise regionally or by PFI service provider.	Improved contract management leads to better value services and more financial deductions for underperformance (estimated to be worth £15m a year).	Easy to implement with no legislative changes required and possible under existing STP arrangements. Potential for far higher savings in wider estates and facilities management.	A significant minority of trusts may not be able to make deductions. Estimated savings that could be made small in relation to financial challenges facing the NHS.	Existing STP structures facilitate staff sharing.
Centralise part of the PFI interest payment to alleviate the financial burden on local NHS trusts.	✓			Centralise the part of the PFI interest payment which is greater than the trust's cost of borrowing from the government.	If excess interest costs were centralized, over the past three years trusts would have saved £621m. Including inflation costs the saving rises to £1.3bn. In 2016/17 alone this totals savings of over £400m which would reduce their deficit by 30%. Over the remainder of the contracts £3.5bn could be saved in excess interest charges across all trusts.	Easy to implement with no legislative changes required. Represents a small proportion of the Department of Health's budget (between 0.17% to 0.37%).	Represents a transfer from trusts to the Department. With a tight budget this involves offering financial relief at the expense of other trusts or areas of health spending (e.g. public health).	Could be easily implemented as income credits to NHS trusts as already happens with PFI support income.
Use a windfall tax to deal with the excess profits made by PFI companies.		✓		A windfall tax on the gains made by SPVs from falling corporation tax rates from 30% to 20%.	The tax could raise £84m from 2008-2015 and is estimated to raised £106m from 2016-2020.	Would bring in increasing tax revenues over time (as profitability increases). A simple and equitable way to cap profit making.	Revenues received would be low relative to amount paid in unitary payments. Could encourage shifting of profits from SPVs to owners/lenders via loans.	Will require legislative changes. Could be legally challenged on the grounds of unfair discrimination.
Terminate or buyout the PFI contracts.	✓		✓	Either via voluntary termination or termination due to persistent failures (default) by the PFI operator.	Voluntary termination ends the PFI contract entirely. Termination due to persistent failures by the PFI operator allows a new PFI operator to be found or for the contract to be terminated but compensation needs to be paid. 16 out of 81 Trusts (20%) with a PFI scheme said that they had reached the point where they had the right to terminate their PFI contract in the last 3 years.	In the case of voluntary termination the trusts gets to leave the PFI contract entirely and in-source all services. For termination with retendering in theory the trust should get an improved level of service without paying more.	May not adequately address the sense of poor value for money of PFI contracts. Time consuming and resource intensive process.	Trusts lack the financial resources to pay for a termination. Departments have limited headroom in their budgets too.
Nationalise the PFI operating company (the SPV)	✓	✓	✓	Pass legislation to nationalise PFI SPVs taking on all their debts and obligations. Then renegotiate the SPVs' debts, remove private profit margins, and gradually end outsourcing.	Nationalisation is estimated to cost £2.6bn in compensation for the SPVs' owners. Savings from the removal of the SPV's profit margin (£1.4bn annually) are expected to outweigh the initial compensation cost in under two years.	Avoids the restrictive nature of PFI contracts. Avoids the need to negotiate changes with each SPV individually.	Cost of compensation will be contentious. Could trigger wider crisis of confidence in government's willingness to honour its debts. Need to build up capabilities of the public workforce if outsourcing ends.	Breaking swaps is still an uncertain area. It is unclear how debt renegotiations could be agreed without legal force. Need to build up capabilities of the public workforce if outsourcing ends.



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