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APSE Briefing: Managing the Expiry of PFI Contracts
House of Commons Public Accounts Committee Fifty First Report of Session 2019-2021

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1. Introduction

In June 2020 the National Audit Office published its report ‘Managing PFI assets and services as contracts end’ which rather than considering the value for money aspects of PFI contracts instead concentrated on the background to PFI, the contracts due to expire (with a focus on England although PFI contracts are still in operation in the devolved administrations) and the roles and responsibilities of key stakeholders. The NAO report also considered the skills and capabilities of authorities (the public bodies responsible for PFI contracts) for the expiry process and how they were preparing for the delivery of contract expiry.

Drawing on the NAO report the House of Commons Public Accounts Committee (PAC) has now published its report ‘Managing the Expiry of PFI contracts’. This briefing explores the recommendations and findings of that report and suggests ways in which authorities should now start to explore the issues raised.

2. Background

The PAC reports that The Private Finance Initiative (PFI) was used from the early 1990s to build over 700 public infrastructure assets. These typically included schools, hospitals and roads as well as prisons, waste and street lighting schemes.

Essentially, as highlighted in both the NAO and PAC reports, the PFI deals involve the public sector entering into long-term contracts with a private sector company. The company is usually a special purpose vehicle created to finance the project, through both debt and equity investors. The company will then design and build the asset, and most often in schemes known as DBFO Schemes, they would also finance and operate the asset. For the lifetime of the contract, following construction, the private company continues to operate and maintain the assets, together with associated services. This can generally be between 25–30 years. The public sector is obliged, under the contract, to make annual payments to the PFI company to cover debt and interest repayments. However, the finances are also used to provide payments to shareholder by way of dividends, asset maintenance, and in some cases other services like cleaning.

The PAC sets out that a number of these contracts are now expiring and over the next 10 years, an estimated 200 PFI projects will finish. The committee points out that this represents around £10 billion worth of assets and in most cases, upon expiry of the PFI contract those assets transfer back to the public sector.

The PAC states that this complex arrangement means that several actions are required by the public body in preparation for the end of the PFI scheme: -

- The authority has a duty to ensure the private company has completed any scheduled or reactive maintenance, including any rectification work, needed to bring the asset up to the condition stipulated in the contract.
- Second, the authority needs to decide if the assets and services are required after expiry and, if so, how the asset will be maintained, and the services provided.
- It is ultimately the responsibility of the authority to manage its PFI contract, including the expiry process.

Whilst the PAC points to the IPA (Infrastructure and Projects Authority) as the Government's centre of expertise, questions are asked, within its report, about the efficacy of current arrangements and resources to support public bodies as PFI contracts end. Whilst many PFI contracts will have a Government Department as a sponsor, and the Treasury indirectly funds the contracts through departmental budget allocations, support is needed to the authorities (public bodies) who are ultimately responsible for exiting the PFI arrangement and in many cases, this will be local authorities.

2. Main conclusions and recommendations from the PAC report

There are a number of recommendations arising from the report and these are as follows: -

1. Government has started to deal with the expiry of PFI contracts, but there remains a lack of urgency and overall plan.

Over the next 10 years, more than 200 PFI projects, representing assets worth over £10 billion, are set to expire. The IPA estimates it takes seven years to adequately prepare for expiry, meaning that work should have already started on those that will be expiring soon. Transferring the responsibility for maintaining the assets and running the service, to the public sector, after contracts expire, represents a significant risk to government as a failure to prepare sufficiently far in advance could leave the public sector exposed to major disruptions to vital public services. The government has acknowledged the seriousness of this challenge and has taken some action to address the risk posed. The Treasury gave the IPA an additional £2 million in the 2020 budget which it has used to develop a PFI contract management programme. This includes a health check tool designed to evaluate the expiry risk of all individual contracts ending in the next seven years. The IPA aims to review 55 contracts by 31 March 2021 using this tool. The IPA has also been developing PFI expiry guidance since 2019, which remains unpublished. The Treasury and IPA are discussing what additional support is to be provided, and by what level of government, but no decisions have yet been made.

Recommendation: ***Within 3 months, the IPA should publish a plan for how it will support all public bodies with expiring PFI contracts, beyond those expiring in the immediate short-term, including what they will deliver and by when. It should also proactively publish guidance for authorities. HM Treasury should write to key departments encouraging them to develop sector specific PFI expiry guidance.***

2. The IPA does not yet have the data it needs to fully understand the challenges of managing the expiry of PFI contracts.

The PFI contract is central to understanding the potential expiry risks an authority may face. However, these are long, complex documents which have been subject to multiple revisions over time, as many as 75 variations in one example. An authority may not hold a complete version of the contract, with either part or all of it lost. The contracts are not always easily accessible, sometimes being held on older technology such as CD-ROMs. A lack of standardisation in the early PFI contracts means that the clarity of each contract's expiry clauses can vary, exposing authorities to different challenges depending on the contract's age. The IPA does not hold a central registry of all PFI contracts as it does not consider creating this to be value for money. It has held discussions with key departments about introducing registries, but these are not yet widely in place. Instead, the IPA collects and publishes limited information on each of the 700 contracts, covering the capital value of the project, annual payments, the date the contract was signed and contract length. This does not include the date the contracts will expire. The IPA has started to collect contracts via its health check tool, but this is on a small scale.

Recommendation: ***The IPA should write to the Committee within 3 months with an update on the thematic PFI expiry challenges that it has identified following its review of 55 contracts and how it proposes to address them. In addition to this, the IPA should compile a central list of all PFI expiry dates to help authorities prepare for their conclusion.***

3. Many authorities currently lack the skills, expertise and capabilities to successfully deliver PFI contract expiry, with locally managed contracts most at risk.

The IPA recognises that there is a huge demand for skills, expertise and capabilities in contract management—all of which are currently in short supply. Contracts owned by local bodies, which represent over 80% of the total portfolio, are the most concerning because expertise has dwindled as resources are prioritised elsewhere. Local Partnerships consider the best prepared authorities to be those with multiple contracts, as they will more likely have maintained a PFI team throughout the life of the contract. However, 182 authorities own just one contract. The IPA accepts that filling the skills gap with consultants could be expensive and not the best value for money option. Part of its PFI contract management programme is therefore focused on building capability and recruiting additional staff to develop a central pool of resources. This so far consists of just 17 people, although more people are expected. This is not enough resource to support all 700 contracts. Local Partnerships also has a small team of experts working on PFI and provide training on a reactive basis if an authority requests support.

Recommendation: ***The Treasury and the IPA should write to Committee within 3 months outlining how they plan to fill the current skill shortages, focusing particularly on those authorities with limited funds to recruit or buy-in external support.***

4. The IPA is not clear what support will be provided to authorities with expiring PFI contracts, and who will provide that support.

Each individual authority is responsible for managing the expiry of its PFI contract. When an authority needs help, support is often lacking, or it is not always clear how to access it, with varying degrees of support available from multiple sources across central government. The IPA is building capacity and plans to provide support and advice via its contract management programme. Local Partnerships provide training courses and lessons-learned examples when requested, while the sponsoring department is responsible for drawing on the expertise at the IPA. Some smaller authorities with multiple PFI contracts are being managed by a single person and could benefit more from additional capacity rather than training courses or specialist advice. The IPA asserts that it is working on proposals on how to provide additional resources, on top of those already available at the centre, and whether this is done by departments or regionally. Decisions about this are still outstanding, exacerbating the lack of support for those local authorities most at risk.

Recommendation: ***The Treasury and the IPA should set out, within 3 months, their plan for providing support to all PFI contracts, especially those owned outside of central government. This should cover: -***

- ***What support will be made available, including how additional funding will be provided to authorities with limited resources or those with the most challenging contracts.***
- ***Who is responsible, between the Treasury, the IPA, departments, and local government, for providing support.***
- ***The circumstances under which authorities can access different types of support and the process they need to go through to obtain it.***

5. [The PAC is] concerned that the approach to managing the expiry of PFI contracts risks authorities working in silos rather than collectively securing value for the taxpayer.

In the education sector, there are examples where the ownership of the PFI assets and the responsibility for managing the contract are not aligned. When a school is converted to an academy, it is no longer the responsibility of the authority, but is instead run by an independent academy trust and receives funding directly from the Department of Education. The authority, however, remains responsible for administering the PFI contract until it ends, despite not inheriting the assets. This can create perverse incentives to protect budgets and limit expenditure on managing the contract, especially during the expiry phase, potentially putting taxpayer interests at risk. The academy trust acquiring the assets may inherit a 'liability'— the cost of bringing the assets back up to usable condition. The potential risk to the Department for Education is significant with around 300 PFI schools already converted to academy status. This is a very complex issue and further clarification is needed.

Recommendation: ***Within 3 months, the Treasury should outline how it is ensuring taxpayer interests are being protected when the expiry of PFI contracts creates a change of asset ownership between public bodies.***

6. The IPA has not set out a clear escalation process to avoid disputes between the public and private sector going through the courts.

At expiry, all parties will want to maximise value from the PFI contract. Authorities will want to ensure the assets are returned to the public sector in the condition stipulated in the contract, with all maintenance and rectification work completed before expiry. The PFI company will want to reduce expenditure in order to maximise payments to shareholders. These misaligned incentives can create disputes. The formal process for resolving disputes is outlined in the PFI contract and will usually require an expert panel to make a judgement. If this does not lead to an agreement a resolution is sought through arbitration or the courts. This process can be long, taking a minimum of 10 months in some cases, and prohibitively expensive for some authorities. This can lead to a situation with a small, under-resourced authority dealing with a large, well-resourced PFI company. There are some examples of good practice, such as Highways England agreeing an informal disputes resolution procedure with the PFI company, which is quicker and cheaper.

Recommendation: ***The IPA should publish a disputes protocol, outlining how disputes can be escalated by authorities, and the steps that can be taken to ensure disputes only need to be resolved by the courts as a last resort. Where disputes do materialise, the IPA should conduct a review to determine whether it is a one-off disagreement or a wider problem that may impact other contracts.***

7. The IPA has not outlined clearly how it plans to engage with investors to ensure that authorities have access to all information needed to manage the expiry process.

Authorities need to monitor the performance of the PFI company to ensure it is delivering the services that taxpayers are paying for. Transparency can be a problem and the IPA recognises that there are some difficult investors which adopt an approach of 'asymmetric information' where the PFI company holds much more information on the performance of the contract compared to the authority. The IPA plans to engage directly with investors to hold them to account, ensuring that information critical to managing PFI expiry is shared with the authorities, but has not yet set out what this will look like in practice. The IPA is also looking to develop a protocol outlining how investors should operate during the expiry process, but this is not yet available. Authorities can withhold a proportion of their annual payments to encourage non-cooperative PFI companies to carry out maintenance, but this is not always an option. Some authorities can also build up retention funds to pay for any identified rectification work but there is a risk that these are not sufficiently large and as these are contractual arrangements they cannot be unilaterally increased later in the process. IPA does not yet have a solution to these scenarios or the actions it would take in response.

Recommendation: ***The IPA should write to the Committee within 3 months outlining the steps it is taking to ensure PFI investors are being fully transparent and compliant with contracts, and what action, if any, it will take if an investor if found to be deliberately non-co-operative.***

APSE comment

There are clearly a number of alarming issues which arise from the PAC report, and indeed the earlier report of the National Audit Office.

In some senses many of these issues were entirely predictable. The conflict between public assets being treated as an investor commodity, for the purposes of PFI finance, was always going to create a degree of conflict; particularly at the end of life where reinstatement and delivery of the asset in an agreed condition was bound to create disputes. Moreover, the stripping out of public sector capacity to effectively manage PFI contracts was always a point of contention. The idea of reported performance from PFI contractors relied too heavily on mechanisms favoured towards the providers and not the client authority.

It is also worth noting that whilst there is a relatively small block of investors, able to manage the PFI investments across their portfolios, the public sector clients are spread across multiple authorities. This creates a further imbalance in resources and capacity to manage expiring contracts, with the 10 largest private investors in PFI owning more than 50% of the contracts.

The process of PFI contract expiry also carries significant financial risk alongside the risk of service disruption. This is because any cash remaining in the PFI company is typically distributed to shareholders. This creates a perverse incentive to hold money in the company. Towards the end of a contract works such as maintenance or rectifications, to deliver the asset back to the public sector in the condition agreed within the contract, may of course be depleted, and therefore this process discourages end of life maintenance and rectification works. If an asset is handed back in a poor condition, it is difficult, if not impossible, to recover any money owed.

As pointed out by the NAO in its report special attention should be paid to on-going maintenance and the lifecycle fund. The lifecycle pot is money built up during the contract to pay for planned, periodic maintenance. However, the NAO found many authorities felt this lifecycle pot was insufficient to cover the costs that it was intended to, and that ongoing monitoring of the assets was hindered by poor data and information. Indeed, many authorities reported that information for monitoring purposes, that ought to be released under the terms of the contract to enable monitoring, was inadequate.

The difficulties in monitoring asset conditions, coupled with the perverse incentives around money remaining in the company, clearly creates the conditions upon which the likely transfer of an asset in a poor condition, coming back to the public sector at the end of the contract, is heightened. Typically, this might include making assets last longer than intended in order to keep more money in the lifecycle pot.

A number of emerging issues therefore are worthy of note: -

- The asset conditions survey is seen as critical to the management of the expiry of the PFI contract. In many cases this is not done or not done early enough to enable effective rectification of the issues. It also raises issues about available skills to conduct, report and act on such surveys.
- A lack of performance information about the asset can hinder negotiations around the expiry of the contract and insufficient information and access to that information.
- The people with the knowledge and expertise at the start of PFI contracts are often not around at their expiry creating a knowledge gap.
- There is a lack of comprehensive information about the contract details and variations, and in some cases no certainty as to expiry dates or what is on the horizon.
- Decisions need to be considered early on in the process as to how the service continuity element will continue at the expiry of the contract – for example bringing services in-house.
- Authorities are attempting to deal with PFI expiry on top of their existing workloads and in many cases poorly resourced legal, property and services teams. This is particularly acute in authorities where there may be only one PFI in place, leading to a skills and resources gap.

Lessons can be drawn from the experiences of local authorities in insourcing outsourced service contracts. In some cases, such as leisure contracts, assets were included within the original outsourced contracts, though not transferred to providers, and insourcing those contracts has often involved an asset conditions survey and significant cost in upgrading and rectifying the asset to enable its continued use or disposal as part of a subsequent asset rationalisation approach.

So too lessons can again be drawn from insourcing service contracts with an approach which involves the following highlighted in APSE's recent report 'Rebuilding Capacity: The case for insourcing public contracts' . This report highlighted the following steps when considering insourcing and could easily be applied to the process for the expiry of service element contracts in PFI schemes: -

- **A calendar of review:** Knowing what to expect and when and ensuring sufficient planning time (suggested as ideally two years)
- **Performance Information**: Gathering of performance data to ensure there is knowledge of successes and failures
- **Consultation:** Consultation with key stakeholders so that new service arrangements better reflect current and emerging needs (than those anticipated at the original outsourcing)
- **Public policy integration:** This approach takes into account newer public policy needs whether that is greener environmental considerations or matters such as social value in how the contract will be delivered
- **Capacity, workforce and skills:** To look at how barriers to insourcing can be overcome, where a service may sit within a newly insourced provision, how to rebuild and use capacity, such as from a TUPE workforce arrangement or existing council teams, and develop a skills strategy
- **Multi-disciplinary project teams:** Bringing together effective teams to manage the process, including finance, legal, HR and operational specialists

The above is by no means an exhaustive checklist but is included to highlight the fact that, whilst the expiry of PFI contracts is daunting, local authorities in recent years have effectively managed insourcing on previously outsourced contracts. They have done so whilst developing more effective service delivery methods and approaches which have enhanced public policy outcomes for local areas.

APSE member councils are invited to a **FREE** online event on the issues raised within this briefing which will include finance, legal and HR experts sharing their views and ideas on this issue. **To register your interest in this event please use this link.**

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