

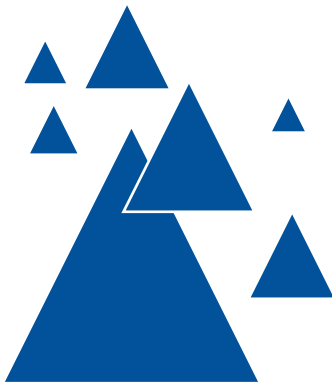
THE  
INSTITUTE OF  
CHARTERED  
ACCOUNTANTS  
OF SCOTLAND



# Financial Black Holes: Accounting for Privately Financed Roads in the UK

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Pam Stapleton    Peter MacDonald



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by

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## LIST OF ABBREVIATIONS

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ALB	Arm's Length Body
AO	Accounting Officer
ASB	Accounting Standards Board
CGF	Credit Guarantee Facility
CIPFA	Chartered Institute of Public Finance Accountants
CPI	Consumer Price Index
DfT	Department for Transport
DoT	Department of Transport
DBFO	Design, Build, Finance and Operate
EIB	European Investment Bank
ESA	European System of Accounts
EC	European Commission
EEC	European Economic Community
EU	European Union
FETA	Forth Estuary Transport Authority
FMI	Financial Management Initiative
FoI	Freedom of Information
FRAB	Financial Reporting Advisory Board
FRS	Financial Reporting Standard
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IPPR	Institute of Public Policy Research

IPSAS	International Public Sector Accounting Standard
IPSASB	International Public Sector Accounting Standards Board
LIFT	Local Improvement Finance Trust
MEL	Midland Expressway Ltd (MEL)
MIG	Macquarie Infrastructure Group
NAO	National Audit Office
NATS	National Air Traffic Service
OECD	Organisation of Economic Co-operation & Development
OGC	Office of Government Commerce
ONS	Office for National Statistics
PAC	Public Accounts Committee
PFI	Private Finance Initiative
PPP	Public Private Partnership
PSC	Public Sector Comparator
PSND	Public Sector Net Debt
PUK	Partnerships UK
PWC	PriceWaterhouseCoopers
PWLB	Public Works Loan Board
SBL	Skye Bridge Ltd
SNA	System of National Accounting
SPV	Special Purpose Vehicle
TEN	Trans-European Network
TEN-T	Trans-European Network - Transport
TfL	Transport for London
TTF	Treasury Task Force
UN	United Nations
VFM	Value for Money

# F

## OREWORD

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Recent years have seen a change in how public assets are financed with a move towards more private finance, particularly in the transport, defence, health and education sectors. This change in policy and the additional complexity involved in such schemes raises important questions for reporting and accountability. How can the public understand where public money is going, how it is being used, whether it is value for money, the risks involved and the extent of future commitments and liabilities?

This report examines whether the current reporting and disclosure for privately financed projects in the road sector delivers accountability for public monies. The study includes an analysis of the disclosure and reporting of six UK road projects, including the M6 toll road and the M74. The report finds that the reporting by both the public and private sectors is limited and opaque. The lack of information makes it very difficult for the public to assess whether the additional costs involved in private versus public finance are commensurate with the benefits and risks to the public sector. The authors conclude with recommendations in respect of public private partnerships across the public sector in terms of: additional guidance to public authorities; disclosure of additional information in public sector accounts; improved access to information on private sector partners; and release of existing documentation on individual project's development and assessment.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also been happy to support this project. The Committee recognises that the views

expressed do not necessarily represent those of ICAS itself, but hopes that the project will encourage debate on how accountability can be achieved for private finance projects.

David Spence  
Convener, Research Committee  
November 2008

# A

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# **E** XECUTIVE SUMMARY

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## **Introduction**

It is a well established principle that citizens, or at least their political representatives, can see how society's resources are being used. However, the increasing amount of public money now spent outside direct state control raises questions about whether the system of public expenditure reporting and disclosure can deliver accountability for public monies.

This report seeks to understand the implications of the turn to private finance for accountability to citizens. It examines empirically the financial reporting and disclosure of expenditure on Public Private Partnerships (PPPs) in the roads sector by both the public and private sector partners and the government, as reflected in national statistics, in order to establish the degree to which the reporting of PPPs meets the Treasury (2003) ideal that it should provide accurate, transparent and credible accounts that allow the public to judge the scope, direction and sustainability of public spending and investments.

The roads sector was chosen because PPP takes a significant proportion of the roads' budget, and it is the largest and most international of the PPP sectors. The financial viability of road projects depends upon the ability to generate sufficient traffic to recover the full costs over the life of the contract, including the cost of debt and equity. But should traffic flows be low or lower than predicted, then the roads will operate below capacity, making them difficult to fund. This then necessitates some combination of higher tolls, capital grants and/or public subsidy, distorting rational capital prioritisation and resource allocation.

Consequently, whether government and/or users fund the service, this policy raises questions about how the public sector's contribution and

forms of support are accounted for and disclosed at agency, governmental and national income accounting levels. The public therefore have a legitimate interest in scrutinising their cost and the financial viability of both the projects and their operators. Such scrutiny presupposes the availability of clear, relevant, reliable and timely information about public expenditure and future commitments.

## Research strategy

The research strategy is three-fold. First, literature is reviewed to understand the operation of the policy, current reporting practices and the degree to which they deal with the complexities created by PPPs. This review is then used to devise a governance-based reporting framework.

Second a case study method is used. Six PPP road projects were investigated, with a combined capital value of £1.3bn, that is, 40% of the total capital value of signed deals for roads and bridges. The cases include large-scale projects, commissioned by different types of public entities, and embrace a variety of different financing and funding regimes. A traditional public sector procurement project is used for comparative purposes.

Third, a governance-based reporting framework is used to analyse the actual reporting by both the public and private sector partners for each of the cases. The methodology relied on an analysis of documents that are either in the public domain or were requested under the *Freedom of Information Act 2000* or the *Audit Commission Act 1998*. The annual report and accounts, *ex ante* business cases, contract documentation, official and regulatory reports, business plans, *ex post facto* evaluations and project reviews were sought. In some cases, clarifications from both the public and the private sectors were sought via email, telephone, and face-to-face discussions.

## Research questions and findings

The research posed four inter-related questions and the following summary shows the major findings for each question in turn.

### ***What additional problems does the PPP policy create?***

PPPs have become the keystone of the British government's reform of the public sector, and their scale and scope are both significant and rising, especially in the roads sector, but the problems surrounding them take several forms.

Firstly, the context in which PPPs operate and the operation of the policy differ from that set out formally in the law, regulations, concessions, licences and government budgets, with the result that the real distribution of risk and costs may fall more on taxpayers and users and less on the financiers than the apparent distribution would suggest. Secondly, PPPs remove public expenditure from the direct control of the public sector and establish contractual relations over very long periods of time that have the effect of committing future governments and taxpayers to expenditures that impact on these and other public services.

Thirdly, the institutional arrangements for the financial reporting of PPPs do not provide disclosure that is useful for the public. Accounting for income streams, assets, liabilities and any contingent liabilities is more complex and controversial than accounting for traditionally procured infrastructure and services. Public sector accounting has now become embroiled in issues that have long been problematic in the private sector. These complexities limit the usefulness of the private sector reporting framework for the reporting on and accountability of PPPs.

### ***What is the European Union's role in PPPs?***

The EU plays a limited direct role in PPP policy or individual projects. As such, PPPs are essentially an issue for each member state, and there is therefore a wide variation in the use of the policy which inevitably gives rise to tensions between political, technical and commercial interests. The EU's role is nevertheless important for a number of reasons. First, its rules on procurement, competition and competitive dialogue impact on the way that projects are designed, advertised and negotiated.

Second, since the EU is broadly in favour of PPPs there are institutional pressures to facilitate this method of procurement by adopting accounting treatments that encourage the policy. The EU formally approves IFRSs for unit level reporting and in terms of national accounting, Eurostat, the EU statistical office, has provided guidance for reporting PPP assets in the *European System of Accounts*.

### ***What reporting and disclosure is needed for public accountability?***

This study identified three inter-related information flows. First, is the traditional upward flow from public authority to Parliament. The second and newer flow, the downward flow of information to citizens has become increasingly important as a legitimising rhetoric of public service reform. While it includes external scrutiny by Parliament, it is also wider, embracing non-financial information about access to services, service performance, and transparency and equity in resource allocation.

PPPs give rise to a third and horizontal flow, from the private sector partner acting as *de facto* public authority. Information held by private sector companies is also crucial for accountability for public expenditure. Without the horizontal flow, both upward and downward accountability has little substantive meaning.

In the context of PPPs, the public needs to be able to understand: the basis for and nature of the procurement decision; the costs of contracts; the values of any reported assets and liabilities, including contingent liabilities; the form and amount of any public support; the financial viability of both the projects and their operators; and the termination arrangements for completed projects.

Thus accountability to the public implies forms of reporting and disclosure over and above the private sector oriented financial statements that enable judgements about value for money (VFM) and the impact of large projects on budgets. Accountability also implies information that is straightforward to locate and understand.

### ***To what extent does current reporting of PPP projects provide public accountability?***

This study has shown that there is a lack of clear, consistent and complete information, designed for use by the public and provided on a routine basis by all levels of both the public and the private sector. Not only is the routine reporting inadequate, the right to additional information via the *Freedom of Information Act 2000*, and the *Audit Commission Act 1998*, applicable to England and Wales, and equivalent legislation for the regional governments, that provide for public access and scrutiny of local authorities, is very limited. More information is forthcoming when the level of popular opposition to a project provides the impetus for press articles and/or investigation by the National Audit Office (NAO) or its regional counterparts.

The public sector has adopted a framework of reporting intended to meet the needs of shareholders as investors. This means that in the context of design, build, finance and operate (DBFO), as the Private Finance Initiative is known in roads, information of value to citizens, especially in relation to actual against expected expenditures, estimates of future expenditures, risk transfer, and contingent liabilities, is not

reported as part of the annual report and accounts. In the private sector it has long been recognised that the presentation of consolidated accounts for large diversified organisations is problematic for shareholders because it disguises the risk profiles of individual segments. This is now being replicated in public sector consolidations where departmental accounts made up of numerous public authorities may disguise the risks involved in the turn to private finance. The lack of information provided by the public authorities means that the main source of financial information relating to the cost of an individual project is the special purpose vehicle's (SPV) financial statements, but these too have their limitations.

First, while the SPVs and their sub-contractors should be the source of horizontal accountability, their reporting is both limited and opaque. Second, their complex group structure means that there is little disclosure of related party transactions. Thus the web of sub-contracting and the accounting regulations that permit close companies to hide behind the 'corporate veil' makes it impossible to see where public money is going, and difficult to assess the total returns to the private sector. Furthermore, although the public authorities and the NAO have the right to examine the books of account relevant to the contract throughout the extended supply chain, there is as yet no publicly available evidence that either have done so.

The additional annual cost of private over public finance on DBFO projects, assuming the same level of debt, is conservatively estimated at between 16% and 40% of revenues. The additional financing cost of the M6 toll road is estimated at 8% of revenues. The additional total cost of the completed projects, the Dartford Crossings and Skye Bridge, was similarly estimated very conservatively at 7% and 25% of revenues respectively. This additional cost must affect the public authorities' budgets and create affordability problems.

The additional cost is attributed to the cost of risk transfer, but the lack of information about the original bids, the expected and actual traffic flows, the expected and actual payments, any penalty deductions, the

cost of operating and maintaining the roads, contractual performance and any contractual changes means that the public cannot assess whether such costs are commensurate with either the benefits to the public sector or the risks to the private sector. Despite this, there has been no *ex post facto* examination of the additional cost of private finance by the public authorities themselves or the public watchdogs.

## Conclusion

These findings are important because other forms of private finance are proliferating, and in connection with projects in local authorities and non-departmental public bodies where reporting is more diffuse, the accountability issues may be even more problematic.

The lack of consistent, comparable, and understandable financial information in the context of PPP makes it difficult for the public to understand where public money is going, how it is being used, and the extent of future commitments and liabilities. This is not to say that there were ever any ‘good old days’. Rather, the increasing expenditure outside the direct control of the public bodies creates additional reporting problems.

The absence of clear financial information means that an informed public debate about public and fiscal policy is impossible, which may lead to a wrong policy choice. More fundamentally, public discourse becomes meaningless. It ceases to be about finding solutions to broader social problems but becomes an exercise in justifying decisions already made.

## Recommendations

When calling for more disclosure, which is clearly necessary in respect of PPPs, it is important to be mindful of both the costs and benefits associated with information provision. The recommendations

are targeted in four areas: (i) guidance to public authorities; (ii) quality of annual public sector information; (iii) information about the private sector partners; and (iv) information release. Each is considered in turn.

### **Guidance to public authorities**

Various international as well as national entities such as the Treasury, CIPFA and the Audit Commission provide guidance to public authorities on reporting and accountability issues, for example the recent Treasury guidance on implementation of IFRSs (Treasury, 2008b). Governance guidance to public authorities should include:

- The specification of how horizontal and downward accountability streams to private sector partners and citizens are expected to operate in the same way as the upward accountability stream to Parliament is recognised. That is, the intended mechanisms by which governance of the partnership relationship and accountability to citizens are to be achieved should be specified in a manner similar to the guidance that is provided about the role and duties of the accounting officer;
- The development of guidelines, based upon experience gained from the profile of Freedom of Information (FoI) requests, leading to greater routine disclosure of information relating to PPPs. That is, FoI requests to one reporting entity should form the basis for new forms of reporting throughout the public sector, so that eventually the numbers of one-off FoI requests decline;
- A common approach to locating financial information should be recommended for public sector websites; and
- The requirement for public authorities to publish succinct summaries of long legalistic contracts.

## Quality of annual public sector information

Public authorities already produce information that could and should be released. Presently such information is aggregated in public sector accounts, so the recommendations below focus on the disaggregation of such data:

- Disaggregated information about the costs of large PPP schemes should be routinely provided in the accounts to improve data collection by the Office for National Statistics (ONS) as well as for accountability purposes;
- Disaggregated information about individual large-scale PPPs should be reported in the accounts to provide information about the current year's payments, expected payments and future commitments;
- There should be a breakdown in the accounts of the unitary charge between availability and service elements, and amounts deducted for poor performance;
- An explanation of the risk assessment leading to any off-balance sheet treatment for PPPs should be disclosed, making the judgement reached under *FRS 5* and *IFRIC 12* clearer;
- Information on all contingent liabilities together with assessments about the probability of crystallisation should be reported by the public authorities and collated and published by the Treasury in accordance with the recommendation from the EU (EMU, 2003) that quantitative information about contingent liabilities should be disclosed; and
- Actual and budget revenues and costs should be compared and disseminated in the same document with an explanation as to why large variances have occurred.

## Information about Private Sector Partners

Better control over the private sector partners must be established and better access to data obtained. Recommendations include the following:

- All public authorities should provide comprehensive details on their PPP projects to the ONS so that the ONS can create a complete list of SPVs and their PPP related debt;
- Public sector external auditors should use their power to roam through the extended supply chain, and determine if partners are viable and specifically that adequate provisions exist for future maintenance costs on PPP projects;
- Provisions in contracts to ring fence front loaded payments ought to be enforced by the public sector procurers to ensure the future viability of these long term contracts, and disclosed by the private sector partners; and
- The Lord Chancellor should designate private companies that deliver public services as public authorities for *Freedom of Information Act 2000* purposes.

## Information release

Lack of information in the public domain seriously reduces independent evaluation of PPPs, yet there already exists documentation that would assist the public understanding of project development and assessment. Such information is sometimes released by some but not all public entities. The following information should be released by all entities on a timely basis:

- Public authorities should routinely publish their business cases after financial close;
- Public authorities should conduct Gateway Reviews for all PPP type projects, irrespective of start date, and publish them in an agreed timeframe; and
- There should be an agreed limit on the time period when commercial confidentiality may be used as a rationale for non-disclosure.

Without implementing such recommendations, public authorities cannot provide the public with the information needed about the costs, VFM and affordability, or the sustainability of public expenditure, public debt and the government's implicit liabilities.

# 1 INTRODUCTION

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*To protect the treasury from being defrauded, let all public money be issued openly in front of the whole city, and let copies of the accounts be deposited in various wards.... (Aristotle, Politics)*

## **Introduction**

It is a well established principle that citizens or at least their political representatives, the media, trade unions, academics and those with some financial literacy can see how society's resources are being used and that no members of that society are seen to have an explicitly sanctioned unfair advantage over others in relation to how those resources are spent. However, the increasing amount of public money now spent outside direct state control raises questions about whether the system of public expenditure reporting and disclosure, designed in earlier times and recently reformed to bring it in line with private sector corporate governance and accounting practices, can or indeed does deliver accountability for public monies.

This report seeks to understand the implications of the turn to private finance for such accountability to citizens. It examines empirically the financial reporting and disclosure of expenditure on Public Private Partnerships (PPPs) in the roads sector by both the public and private sector partners and the government, as reflected in national statistics, in order to establish the degree to which the reporting of PPPs meets the Treasury (2003) ideal that it should provide accurate, transparent and credible accounts that allow the public to judge the scope, direction and sustainability of public spending and investments.

While the PPP policy has been hugely controversial, this study is less concerned with the claimed advantages of the policy than its broader implications for disclosure given that it is one of the mechanisms that blur the boundaries between the state and the market. This report therefore spans a range of subjects and issues of increasing interest and importance to accountants, the public authorities involved in PPPs, shareholders, policy makers, and the public at large.

This first introductory chapter outlines the background to the study, explains the financial and political significance of PPPs, sets out the research objectives and research approach, and explains the structure of the report.

## **Background to the study**

It is the *sine non qua* of modern democracies that the public, or at least its political representatives, can and should scrutinise public expenditure, as part of the process of holding government to account. But accountability has had many and varying meanings over time. It has been described as a chameleon-like term that attaches to a wide range of causes and agendas (Dubnick and Justice, 2006), but generally it is understood to encompass several notions: who should be accountable to whom, and for what? That is, it is a process of giving and demanding reasons for conduct. In terms of accountability for public policy and expenditure, public authorities should be under control and subject to oversight.

Such scrutiny presupposes the availability of clear, relevant, reliable and timely information about public expenditure, its payments, commitments and liabilities. Over time a range of policies and practices has developed to provide such information, albeit imperfectly. However, over the last 25 years, the boundaries between public and private expenditure have become blurred as public authorities have outsourced the delivery of public services via a variety of mechanisms, including

compulsory competitive tendering and more recently partnerships with the private sector. Such policies and practices are part of a wider move to transform the government into a procurer and regulator of public services rather than a deliverer.

Partnerships involve a clearly defined project where the private sector both finances and shares risks and rewards with the public sector. Such partnerships may be either a joint venture between the public and private sector (PPP), or a contractual arrangement under a Private Finance Initiative (PFI), whereby the private sector designs, builds, finances and operates assets, such as schools, hospitals, roads or prisons, in return for an annual payment to cover the cost of both the capital and service elements (Treasury, 2003). Some examples of partnership structures include:

- A contractual type arrangement, known as Design, Build, Finance and Operate (DBFO) in the case of roads, where the public sector pays for the use of the asset and the services over 30 years, such as the A55, A13 and A74(M)/M74;
- Free standing projects, concessions or franchises: contracts where the private sector charges the users directly via a system of road tolls or fees, as for example Britain's M6 toll road and the Dartford Crossings;
- Free standing projects, concessions or franchises: contracts where there is some mix of both public and user funding for either the construction and/or the service element, as for example the Skye Bridge, which was originally a free standing project, where the government paid some of the construction costs and later subsidised the tolls before ultimately terminating the contract; and
- Joint venture/joint ownership arrangements, where the partnership may charge either the public sector as in health and education, or the users as in the case of National Air Traffic Services.

Several points should be noted. First, while the Treasury makes the distinction between ownership (PPP) and contractual arrangements (PFI), in practice the terms are used interchangeably. Second, the private sector partner in the context of contractual arrangements and free standing projects is typically a consortium constituted as a special purpose vehicle (SPV). This is essentially a shell company, largely debt financed with no recourse to its parent companies, which operates through a complex web of subcontracting to sister companies. The private sector partner in joint ventures may also be a consortium or the subsidiary of a much larger entity. Third, as the above list shows, while the financing comes from the private sector, the funding or revenue stream comes from either the taxpayers and/or users. Fourth, in most cases, but not all, the public authority will assume or resume ownership of the underlying assets at the end of the contract.

As with many policy innovations, the rationale has changed so much over time that even its proponents have described it as 'an ideological morass' (IPPR, 2001). It was originally justified as a way of leveraging in the private finance that the state could not provide. In some countries, it was seen as a way of reducing public sector debt, as currently the underlying asset and its corresponding debt may, if there is sufficient risk transfer, be treated as off-balance sheet, thereby evading the strictures of the European Union's Stability and Growth Pact. In the UK, the policy and the inevitably higher cost of private finance are now justified in terms of delivering value for money (VFM) in the form of lower discounted whole life costs, including the cost of transferring some risks to the private sector, compared with conventional procurement as measured by a public sector comparator (PSC).

While the UK has led the way in introducing partnership arrangements, within Europe there has long been a policy of concessions and management contracts for utilities and transport, particularly in Spain, France and Italy, and decentralised mixed mode financing mechanisms. All these are now included under the umbrella of partnerships. With

the increasing integration of the European economy via the European Union (EU), the EU has begun to consider arrangements in relation to the policy itself, which it broadly supports, its procurement and reporting for national income accounting purposes. Indeed, there has been internationally strong support among policy makers for the turn to private finance in general and roads in particular (see for example Miquel and Condron, 1991; World Bank, 1994; Levy, 1996; Ridley, 1997; Glaister, 1999; Debande, 2002; and Grimsey and Lewis, 2002).

## **The significance of private finance and PPPs**

PPPs in the UK now encompass most sectors and services across the public sector and all types of public bodies, national, local and non-departmental. By the beginning of 2007, the capital value of all signed deals had reached £55bn (Treasury, 2006a). By far the largest spending department was transport with £22bn signed deals or 40% of the total. Within transport, the capital value of signed deals for roads and bridges was £3.2bn.

Where the taxpayers fund the PPP, it has long-term implications for public finances since it converts up front fixed expenditures into a stream of future payments, akin to a mortgage. According to the Treasury (2006a), annual commitments are about £7-8bn a year or £184bn for the period between 2006 and 2034, although this information is incomplete and inconsistent with other sources. While smoothing out the cost of public investment in this way may be advantageous to the commissioning agency, the impact on public finances as a whole and its sustainability needs to be considered. PPPs increase the proportion of public sector expenditure committed to long-term service contracts, which are legally binding, thereby locking in subsequent governments to future expenditure, under conditions where there may be considerable uncertainty about the kind of services that may be required in the future. To the extent that PPPs constrain budgetary flexibility, they

raise issues about the control and sustainability of public investment and expenditure.

Whereas in 1996-97, PPPs took 0.1% of the UK public sector's consumable expenditure, by the end of fiscal year 2004-05, this had reached 1%. But since in practice, PPPs replace expenditure for services previously carried out in house, then the more relevant denominator is the public sector's wage bill, including associated insurance and pension costs: in 2004-05, PPPs had risen to 3% of the wage bill, up from 0.2% in 1996-97. While these figures are low in relation to public expenditure as a whole, PPPs take a significant proportion of some budgets, particularly roads. For example, in the context of DBFO in roads, a Highways Agency official stated that its known commitments were about £300m a year, an amount equal to 20% of its budget for 8 per cent of its network (Taylor, 2005), although it was unclear to which budget he was referring. The proposal for the widening of the M25 would add a further £300m a year, committing 40% of its budget for a small proportion of the network. Taken together, such future payments may in effect constitute 'an explicit off-balance sheet liability ... which has significant implications for future borrowing or taxes', as the International Monetary Fund (2004) pointed out, citing an article in *The Times* (7th July, 2003).

Furthermore, irrespective of whether the taxpayers or the users fund the project, governments may give explicit or more often implicit guarantees such as 'letters of comfort' to the financial institutions that payments will be made to the private sector, thereby in effect underwriting their debts. Irwin *et al.* (1999) note that because the contingent liabilities flowing from these guarantees are rarely recorded in the accounts or budgets, governments may be unaware of the extent of their exposure. This adds to the increasing concern over implicit liabilities relating to pensions, global warming and security (Heller, 2003).

This issue is important in the context of roads, which usually entail tolling. The financial viability of such a road project depends

upon its ability to generate sufficient cash revenues to recover its full costs over the life of the contract, including the cost of debt and equity, under conditions where the demand is rarely sufficient to recover costs. This is after all why most infrastructure and public services have been provided by the state: they are simply too financially risky to be provided commercially on a universal and comprehensive basis. The requirement for financial viability has therefore the potential to distort a capital prioritisation programme based upon a broader economic and social cost benefit analysis in favour of roads that can generate good cash flows where few roads are tolled. But should traffic flows be low or lower than predicted, then the roads will operate below capacity, making them difficult to fund. This then necessitates some combination of higher tolls, capital grants and public subsidy, further distorting any rational capital prioritisation and resource allocation.

The international experience has reflected these financial realities. Silva's report (2000) on the performance of the World Bank's loans for private road concessions, which is supportive of private finance and tolling, notes that such roads are generally successful, without providing any financial details. Nevertheless 10% of concessions by value had to be taken over by government when the concessionaires faced inadequate revenues due to users' dislike of tolls, and/or higher than expected costs, while others had to be renegotiated. She concludes that governments need to address why these projects failed and ensure that projects are made more attractive to both the private sector and the electorate. In order to make projects attractive to the private sector, governments have given explicit debt guarantees and up front grants towards the cost of the investment (Ehrhardt and Irwin, 2004).

Estache and Serebrisky (2004), in their overview of transport PPPs, note that 55% of all transport concessions implemented between 1985 and 2000 in Latin America and the Caribbean were renegotiated due to inadequate demand. New toll roads in Mexico were unsuccessful and had to be taken into public ownership. But a further issue is that

governments may disguise the cost of such renegotiations. Engel *et al.* (2006) report that in the case of Chilean highways, the then government manipulated the accounting treatment of the contract renegotiation, which entailed back loading the payments without disclosing this in the government's accounts. Estache and Serebrisky (2004) conclude that since such projects need a high degree of political commitment at both national and international level to create an effective financial, regulatory and competition regime if private participation is to increase, most such expansion was likely to be in the richer countries.

But concerns have also been raised in richer countries, especially about risk transfer. For example, Boardman *et al.* (2005), in their review of private toll road cases in North America, note that the private sector is adept at ensuring that it is fully compensated for risk-taking, but, at the same time, will go to considerable lengths to avoid the risks that governments seek to transfer, for instance by setting up SPVs that have no recourse to the finances of their parent companies and can therefore walk away from trouble. The authors conclude therefore that governments need to be cautious and to ensure that the private sector actually bears the risks they seek and pay to transfer. Shaoul *et al.* (2006), in their *ex post facto* financial study of the first eight DBFO contracts in the UK, paid for by taxpayers' money, conclude that the cost of risk transfer is very expensive, under conditions where the £220m annual payments appear to be guaranteed by government (Standard and Poor's, 2003) and reporting by both the public and private sector partners is limited and opaque.

Consequently, whether the service is funded by government and/or users, this policy raises questions about how the public sector's contribution and forms of support, for both the capital and the operating elements, are recorded, disclosed and accounted for at public authority, departmental, government and national income accounting levels. Furthermore, even where these are free standing projects with little if any public contribution, the fact that these are essential public services

means that they cannot be allowed to fail, as the UK cases of the Channel Tunnel Rail Link, Railtrack, British Energy, Royal Armouries Museum, National Air Traffic Services and the two Metronet Partnerships with London Underground – some of which were fully privatised companies – have demonstrated. In other words, the government must step in should they become insolvent. Similarly, in Australia, the government has had to take the La Trobe hospital and the Deer Park PPP prison back under public sector control (English and Walker, 2004).

The public as users and taxpayers therefore have a legitimate interest in the projects' costs and the financial viability of both the projects and their operators. To understand the impact on public expenditure and the sustainability of public finance, it is necessary to include not only the size and distribution of the annual payments specified in the contract, but also the cost of any possible buy back of the asset and the possibility that debt guarantees are exercised. That is, any contingent liabilities need to be explained and where possible quantified. All this necessarily requires considerable information, under conditions where the projects themselves and their costs may change considerably over time.

In so far as PPPs are replacing the system of public ownership, financing and funding that developed in the nineteenth and twentieth centuries, when public monies were largely spent in-house, this may render the system of disclosure and control of public expenditure, developed in a previous era, inappropriate. Traditionally, public sector reporting has been concerned with *ex post* annual disclosure and reporting for probity, stewardship, control and sustainability purposes. But the lack of an agreed definition of a PPP and a wide diversity of models create a challenge in developing a consistent reporting and regulatory framework.

## Research objectives and approach

Although there has been considerable empirical research into the financial case for private finance at the point of procurement, there has been little research into the reporting of expenditure under partnership arrangements during the implementation phase. This research therefore examines the reporting and disclosure of public expenditure on UK road projects, in the context of an increasing turn to the use of private finance.

The research poses several inter-related questions:

- To what extent does the PPP policy create new problems for reporting and disclosure and thus for accountability?
- What role does the European Union play in the regulation, development and reporting of PPPs?
- What reporting and disclosure by the public and private sectors are needed to ensure accountability for PPPs?
- To what extent do current financial reporting practices relating to PPPs provide useful information for the public?

To answer these questions, the research firstly reviews the literature as it relates to:

- The policy objectives, appraisal process and practices, implementation, and evaluation of PPPs in general and roads, bridges and tunnels in particular in the UK;
- The case of Spain, which has had the longest experience of road concessions. It concentrates on areas where problems are known to have occurred because they illustrate the implications for reporting and scrutiny;

- The governance literature, since the concept of governance determines the accountability requirements and hence the necessary reporting and disclosure;
- The financial reporting arrangements for reporting PPPs by both the private and public sector partners as set out by the international and national standard setters, including where appropriate the EU;
- The EU/United Nations requirements for government reporting in the context of PPPs, that is, the system of national accounts and fiscal rules, since these rules determine how public investment, debt and expenditure are reported and thus the transparency of national statistics; and
- The EU's policy on and regulation of PPPs, and participation of member states in road projects within the EU.

The purpose of the review is to understand the operation of the policy, current reporting practices and the degree to which they deal with the complexities created by PPPs. The review is then used to devise a governance-based reporting framework that identifies the information that should be made available at various stages of the lifecycle of PPP projects. This framework is in turn used to analyse empirically the reporting practices of a number of partnership arrangements in roads.

The roads sector was chosen because although it is the largest and most international of the PPP sectors, it has attracted little public attention. The cases include large scale projects, with a service element specified in engineering terms, which should be straightforward to identify and find information about. They were projects commissioned by different types of public authorities, embracing a variety of different financing and funding regimes. Some of the contracts had run their course, been terminated or are still ongoing. The projects are restricted to the UK for reasons of access and language, and cover only contractual or concessionary arrangements, since there are no joint venture projects in this sector.

The six PPP road projects investigated in this report are:

- The Dartford Crossings;
- The Birmingham North Relief Road, now known as the M6 toll road – a private toll road designated as a PFI project by Treasury;
- The Skye Bridge, now terminated;
- A Scottish Office DBFO road, the A74(M)/M74;
- A Welsh Office DBFO road, the A55; and
- A Local Authority DBFO road, the Thames Gateway A13 road.

These are compared against a traditional public sector procurement project, the Forth Road Bridge, Edinburgh, because it has been funded by user charges for over 40 years.

For each project, the methodology relied on a documentary analysis. The annual report and accounts, any *ex ante* business cases, contract documentation, any official and regulatory reports, business plans, any *ex post facto* evaluations and project reviews were sought. Since the emphasis is on public accountability, the documents selected are either in the public domain or could reasonably be expected to be so. Where necessary, documents were requested under the *Freedom of Information Act 2000* or the *Audit Commission Act 1998* in England and Wales, which provides statutory rights of inspection of local authorities for a few weeks during the annual audit. In some cases, additional information from both the public and the private sectors was sought in order to clarify particular points or procedures, via email, telephone, as well as face to face discussions.

While recognising the limitations of a case study approach and especially the limitations of studying just a few projects, the report tries to draw some conclusions of a general nature about how the corporate governance and reporting arrangements work in practice to deliver accountability.

## Structure of the report

The report is organised in seven further chapters. Chapter two reviews the development of the PPP policy in the UK as it relates to contractual/concessionary arrangements. It explores the context, development and scale of this policy initiative both in general and more specifically in roads, the nature and operation of the PPP market, the challenges created by PPPs, and develops a reporting framework for the types of information that need to be disclosed for accountability purposes.

Chapter three reviews the development of transport and PPP policies in Europe, the regulations governing their operation, and the nature of road projects that have been implemented in the 15 EU member countries and the new accession countries. It examines the experience of road concessions in Spain, which has had the longest experience of the policy.

Chapter four examines the notion and operation of governance in the public sector. It reviews literature that discusses: the rise of corporate governance in the private sector and its transfer to and development in the public sector; changes to accountability in the public sector that occurred during the 1980s when the public sector underwent reform; the specific features of PPPs that create a particularly complex governance case where there is a need for an accountability stream from the private sector to the public authority, and from the public authority to the public and the executive; and whether and how such accountabilities are provided. This review is used to identify information that needs to be disclosed in the context of PPPs.

Chapter five considers the reporting of PPP projects from the perspective of the public's need to understand the projects' impact on the public purse. It then examines the reporting by both the private and public sector entities within the context of current UK, EU and international accounting regulation, and considers the implications for government reporting in the form of national statistics. It discusses

some of the broader problems caused by the public sector's adoption of the private sector reporting framework. Finally, it reviews some of the specific problems that have arisen, particularly the lack of disclosure that exists at many levels of reporting in both sectors.

Chapter six describes the research approach, focusing on the development of a governance-based reporting framework, based upon these reviews. It then explains the six PPP projects and one public sector project studied, the kinds of information that are publicly available and the limitations of the legislation designed to make such information available to the public.

Chapter seven uses the reporting framework described earlier to analyse the actual reporting by both the public and private sector partners for each of these seven cases and the costs of private finance for both the ongoing and the completed projects.

Chapter eight presents a discussion and conclusions about the issues that have emerged, with suggestions for further research and recommendations.

# 2 THE DEVELOPMENT AND OPERATION OF PPP POLICY IN THE UK

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## Introduction

This chapter has several inter-related purposes: to explain the development and operation of the PPP policy, and the broader regulatory and commercial environment in which it operates both in general and more specifically in roads; to identify the problems created by the policy for reporting and disclosure and thus for accountability; and to suggest the kinds of information needed to ensure accountability for PPPs.

The chapter is structured in five sections. The first explains the development and rationale of the policy, including its scale within specific sectors and the key players. The second analyses the control methodology and process: the criteria that public bodies must satisfy if their projects are to proceed and the government's case for the policy. The third reviews some of the issues that have emerged since the policy has become operational. The fourth outlines the development and form of the policy in the roads sector. This review of the policy then forms the basis for the fifth section which develops a reporting framework that would enable the public, that is, taxpayers, citizens and users, as well as its representatives and government, to understand how public monies are being spent, and the degree to which the projects deliver the expected value for money and are affordable and sustainable. Finally there is a short summary.

## The development of PPP policy

Following the shift to neo-liberal policies in the 1980s, including the privatisation of the state-owned enterprises and the outsourcing of 'non-core' public services, the then Conservative government began to turn to the use of private finance for public infrastructure for stand-alone projects such as bridges and tunnels. In some cases, such as the Skye Bridge, it was the private sector that proposed such deals, a trend which has continued.

In 1992, at the height of the recession and in response, in part at least, to the construction industry, the Conservative government launched the PFI to address the problems of Britain's crumbling infrastructure, whose maintenance and replacement had been ignored since the International Monetary Fund (IMF) imposed cuts in public expenditure in 1976. PFI was conceived as a long term contractual relationship whereby the public sector would procure services from the private sector which would provide the physical asset. The contracts would include penalties for poor performance that would serve to incentivise the private partner to deliver to a high standard. The government argued that despite the higher cost of private finance, VFM would be achieved by: the competitive pressure to secure the contract; and the greater efficiency, expertise and innovation of, and risk transfer to, the private sector.

But the initial take-up from the private sector was far from enthusiastic. A year later, the Chancellor of the Exchequer was forced to admit that progress had been 'disappointingly slow'. He therefore set up, in 1993, a Private Finance Office within the Treasury, with a Private Finance Panel headed by Sir Alastair Morton, Chairman of Eurotunnel, the first private finance project, to advise on how to promote the policy and increase the number of projects, and a Private Finance Panel Executive. Both of these were to be staffed by secondees from the City and accountancy and consultancy firms. In addition, he set up Private Finance Units in the key capital spending departments to

promote and expedite the PFI's implementation. The secondees began actively to promote the policy, organising conferences to sell the PFI to future private partners. Although departments initiated projects, the Treasury took an active part in lining up projects, and through its Private Finance Unit, making them suitable for PFI.

While it had originally and mistakenly been expected that private finance projects would come on top of publicly funded ones, that PFI would provide 'additionality', the Treasury later made it quite clear that private finance would not be an alternative to public money. It would be private finance or nothing. Every public body commissioning capital investment would have to pursue the private finance option. But such active championship of PFI/PPP by the Treasury and government departments raises issues about conflicts of interest if the same public bodies both promote and control these projects (Freedland, 1998), particularly where there is a lack of public finance for conventional procurement.

Despite the Conservative government's best endeavours, PFI proved difficult to get off the ground, with only 62 projects signed by the end of 1996. This was due to the complexities involved, the lack of experience on the part of the public authorities, and legal difficulties, as well as a broader political resistance. Although several road and prison projects were concluded by 1997, it proved difficult if not impossible to close deals in the more sensitive public services such as health and education.

It was the incoming Labour government in 1997 that got the policy up and running and extended it throughout the public sector, by removing the legal barriers, providing subsidies in the form of PFI credits to local authorities to fund PFI projects at least in the early years, and increasing the number of financial advisors in the Treasury to progress the deals. It rebranded the policy as Public Private Partnerships, signifying the extension of PFI to include concessions and franchises, and the policy as a whole to embrace joint ventures with the private sector using a range

of ownership structures. The government made partnerships central to its agenda and used the term interchangeably with PFI.

By the end of 2006, the capital value of the 794 signed PPP deals had reached £55bn (Treasury, 2006a) and departmental estimates of capital spending for signed deals for 2006-7 and 2007-8 indicate that the use of private finance will continue (Treasury, 2007a). Within transport, the capital value of signed deals for roads and bridges was £2.3bn or £3.2bn, according to the Partnerships UK database. But as this demonstrates, years after embracing the policy, the official websites are seriously out of date, inconsistent and incomplete.

Furthermore, not only is it very difficult to get up to date information about the capital value of the signed deals, information about the total or future annual public expenditure implications of each deal or even for each sub-sector or sector is only just being put in the public domain. Annual payments were shown as £6.9bn in 2006-07, rising to £8.9bn in 2016-17, before declining (Treasury, 2007a). Total commitments for all PFI projects between 1995 and 2034, were estimated at £204bn. However, the basis of these projections is unclear. Firstly, the number of signed deals is lower than that listed elsewhere. Secondly, the projections necessarily omit the new deals yet to be signed and the payments still to be negotiated for the later years of the largest scheme, the London Underground PPPs. Thirdly, they are based on estimates made at financial close and are subject to upward revision in the light of inflation and contractual changes. Fourthly, the payments shown for some projects differ from the sums actually paid by the public authority. Fifthly, the Treasury elsewhere reports payments net of expected corporation tax payable (Treasury, 2003). Thus the actual payments are likely to be very much higher and will take an ever increasing amount of the key denominator, the annually managed public expenditure that is still spent 'in house', which is itself falling due to different forms of outsourcing (Pollock *et al.*, 2001).

## Control of the PFI decision-making process

The Conservative and later the Labour governments established detailed procedures for controlling PFI deals, placing great emphasis on the calculative techniques of financial appraisal to be used to measure the VFM to be obtained by using the private sector to deliver public services. VFM is dependent in the first instance upon appropriate arrangements for competitive pressure for all aspects of the bidding, including advisors, throughout the negotiation phase (NAO, 1997).

But large scale projects require and attract a limited number of highly experienced bidders so there is limited effective *ex ante* competition even in the best organized tendering processes (Estache and Serebrisky, 2004). It would indeed be highly unlikely to get more than three or four bidders for large projects as industry concentration means that there are few players. For example, just six infrastructure companies won 50% of the EU roads market and 16 had 90% of the market (Stambrook, 2005). Concentration in the construction industry has increased in recent years following takeovers and mergers and this has led to reduced competition in PPP procurement (Stambrook, 2005). This creates increased risk for the public sector because the companies are large and powerful enough to take on the regulators in the case of conflict and force contract renegotiation on more favourable terms (Molnar, 2003). Within the UK, the National Audit Office (NAO) (2007a) has also reported on the low and declining level of competition for PFI contracts. One in three PFI projects have attracted only two bidders, compared with one in six in earlier years.

Secondly, and this is the aspect that has attracted the most attention, VFM is demonstrated by identifying and discounting the whole life costs of the project as financed under conventional procurement methods and compared against the discounted costs of the PFI option. The scheme with the lower cost is assumed to offer the greater VFM. The comparison also includes the costs of some of the risks associated with

the construction and management of the asset and delivery of services. Since some of the risks are to be transferred to the private sector, for comparison purposes, the Public Sector Comparator (PSC) needs to include the costs so transferred. It is argued that the PFI option will therefore provide greater VFM than a publicly financed alternative where the public sector bears all the risks. In effect, the proponents of PFI are arguing that the difference between the public and private sector cost of borrowing constitutes the risk premium, the price the public sector is paying for greater efficiency, expertise and innovation plus the cost of risk transfer.

But several points should be noted. The highly technical VFM appraisal methodology, established by the Treasury, rests upon the options appraisal technique, which is not unproblematic, particularly in the context of public services, as others have noted (Tribe 1972, King 1975, Ross 1995). The VFM methodology has been extensively critiqued in the research literature, although largely ignored by the corporate literature and the government (Greenaway *et al.*, 2004; Shaoul, 2005). For example, the discount rate to be used in comparing the public and private sector options was raised from 5 per cent, already higher than the social welfare rate of 2 to 4% preferred by welfare economists, to a 6% real annual discount rate and an 8% nominal rate. This would, according to Spackman, a senior Treasury Economist, 'prevent any bias in favour of public sector financing' (Treasury 1991, para 49). The Treasury's Green Book makes it clear that the cost of capital assumption was 'chosen to ensure the efficient costing of central government inputs and outputs *relative to those in the private sector*' (Treasury 1991) [emphasis added]. When the Treasury came to update the Green Book in 1997, despite noting that indexed linked gilts - a no risk stock - had usually been just above 3% in 1996 and low risk stock had been 5%, it retained the 6% rate, a rate closer to the private sector cost of capital at the time.

But as others have pointed out, it is not just that such techniques can be problematic or misused, they are also value laden: 'the myth endures

that techniques in themselves lack substantive content' (Tribe 1975, p75). In the context of investment decisions between public and private finance, what is at stake is not just the selection of particular projects, but also the allocation of resources between the public and private sectors of the economy (Brown and Jackson 1990), and the important distributional consequences that flow from that choice.

Conceptually and methodologically flawed, as the research evidence has demonstrated (Gaffney *et al.*, 1999a,b,c; Pollock *et al.*, 1999), such valuations encapsulated in VFM and set out in the projects' business cases are not generally, other than in health and education, in the public domain, for reasons of 'commercial confidentiality'. The hospital business cases show that the VFM, resting upon uncertain projections of costs far into the future, relies overwhelmingly upon estimates of the cost of 'risk transfer' to the private sector. A study of those risk assessments that are in the public domain show that risk is difficult to measure (Froud and Shaoul, 2001). But, even after risk transfer, the difference between the public and private sector options was marginal (Pollock, Shaoul and Vickers, 2002). In effect, there is a question of whether private finance is likely to deliver VFM as the NAO (2000a) has acknowledged.

Secondly, under conditions where private finance is the only game in town then, as the NAO has acknowledged, there are incentives to ensure that the case favours the private option. It is therefore almost unheard of for the business cases drawn up by the public sector's private sector financial advisors not to show that the private finance route is better VFM than a publicly financed option.

Thirdly, the key government department, the Treasury, both champions and controls the PFI process. The Treasury's Projects Division was initially established in 1997 with a two year life, largely with staff on secondment from the private sector. This was later reconstituted as a PPP, Partnerships UK (PUK), whose mission is to help the public sector deliver: fast and efficient development and procurement of PPPs; strong

PPPs that build stable relationships with the private sector; savings in development costs; and better value for money (Partnerships UK, 2003). Fifty one per cent of the shares are held by private sector institutions, including financial services companies that have been involved in the financing of PPP projects, and others that have PPP contracts.

As well as providing policy support to the government and project support to public bodies, PUK also has equity stakes in the Local Improvement Finance Trust (LIFT) in health and Partnerships for Schools programmes, two programmes aimed at introducing private finance into primary care and education. Furthermore, the majority of the board members come from the private sector, with the public sector represented by only two non-executive directors and the public interest represented through an Advisory Council. The structure, ownership and control of PUK are important because they set the PFI/PPP agenda and reflect the conflict between policy promotion and policy control acknowledged by government (Timms, 2001).

Thus, the government transferred the management of the PFI/PPP procurement process – a task formerly carried out by civil servants, albeit on secondment from the private sector - to a company owned by the very corporations that are closely involved as owners, financiers and subcontractors in such projects (Shaoul *et al.*, 2007a). Legislation was amended to give PUK the authority to do so. This represents a major and largely undocumented change in the process of government. With the *Freedom of Information Act 2000* enabling government to avoid disclosure where it relates to advice on policy formation, this protection is now extended to the government's private sector partners, preventing scrutiny by the general public and its representatives. As a profit making entity that exists to promote partnerships, it institutionalises the potential for conflicts of interest with the private sector vetting the business case for the procurement of a privately financed project. Indeed, the possibility of conflicts of interest was so great that PUK was required by the chair of its advisory council to devise a second and clearer code of conduct to

identify and manage conflicts of interest. However, there is no reference to how this is operating in the most recent annual report available on its website (Advisory Council of PUK, 2007). Furthermore, despite the fact that it receives some of its funding from Parliament, the government made no provision for access to it by the NAO (Bowerman *et al.*, 2003). In essence, at the level of both policy and projects, partnerships are directed by people whose business and social networks have a vested interest in its expansion and are shielded from public scrutiny.

Fourthly, the project and the case is managed and/or vetted by the Treasury, the Departmental Private Finance Units, Partnerships UK, in the case of central government, or 4Ps, in the case of local authorities, all of whom are largely staffed by private sector secondees from firms with a vested interest in the policy. This means that the control process is dominated by parties which have a vested interest in the policy's expansion (Craig, 2006). Under such circumstances, conflicts of interest abound.

One of the most striking examples of the conflict of interests, the resultant poor financial advice and the cost to the public purse, is provided by the case of the National Air Traffic Services (NATS) PPP, which required a government bailout within three months of financial close in 2001. The Department of Transport had paid its advisors, one of whose tasks it was to evaluate and manage the risks to NATS' business, some £44m. This was £17m more than expected and at 5.5 % the proceeds of the sale, among the highest of all the trade sales examined by the NAO (2002a). But despite this, CSFB, the lead financial advisors, failed to evaluate the PPP correctly (Shaoul, 2003). It had ignored evidence and advice that did not fit with the government's and its own desired outcome: a signed deal. CSFB told the NAO that their prime motivation was to gain valuable experience of PPPs in order to win future contracts in this new and expanding market (NAO, 2002a).

Fifthly, the business case demonstrating that the privately financed option is better VFM than conventional procurement is not usually

published either before or after financial close, except in the case of hospitals which do publish their business cases, but only after the deals have been agreed, due to 'commercial confidentiality'. This lack of publicly available information, plus the complexity of the schemes, raises concern not only about political accountability but also the objective nature of the VFM assessment as the Institute of Public Policy Research (2001) noted.

Several points flow from this. The VFM case is necessarily based on estimates of future costs and operates only at the point of procurement. While the crucial element in delivering whole life economy is the risk transfer, the public sector retains the ultimate responsibility for essential and often statutory services for which there is usually no alternative. This, plus government commitment to the policy, means that the revenue streams are assured as the capital markets recognise (Standard and Poor's, 2003). Thus the ability to transfer risk may in practice be very limited as others have suggested (Gaffney and Pollock 1997; Coleshill *et al.* 1998; Broadbent and Laughlin 1999; Mayston 1999; Ball *et al.* 2000; Accounts Commission 2002; and Hood *et al.* 2006).

The government claims that PFI represents VFM, but this is largely based upon the business case used to support the use of private finance, which as explained above is not an independent or reliable assessment. Apart from the London Underground PPPs (NAO, 2000a), the NAO has not carried out any assessments of projects before financial close. While the NAO has carried out numerous assessments after financial close, these were not independent in the sense that they collected new data. Instead the NAO scrutinised, and in many cases criticised, various aspects of the way the business cases were compiled and interpreted, questioning the degree to which the projects demonstrated VFM (NAO, 1997; 1998; 1999a; and 2000a).

While the government has commissioned several surveys of PFI that purport to show that PFI represents VFM, these have been carried out by financial consultants with a vested interest in the policy. The

first, the Andersen report, commissioned by the Treasury, is particularly important (Arthur Andersen and Enterprise LSE, 2000) because it claims that PFI had 'saved' 17% on the cost of conventionally procured projects. However, this is based on a sample of 29 projects (out of a possible 400 projects), whose selection is not explained. Its evidence base is the business cases used to support a PFI deal over conventional procurement, rather than any independent analysis. But even more important, most of the savings come from just a few schemes as a result of the risk transfer to the private sector. Furthermore, about 80% these savings came from just one project, the NIRS2 project for the Benefits Agency run by Andersen's sister company, Accenture, which has become a byword for failure. In other words, the study was based upon anticipated savings that were not achieved in practice.

The second report, commissioned from PriceWaterhouseCoopers (PWC) (2001), does not provide even the most basic information that would enable the reader to assess the methodology and the value of the findings. It is based on the perceptions of senior managers responsible for commissioning 27 PFI schemes, not users, staff or project managers. The report does not explain the sample choice or even provide any evidence about the nature or sector of the schemes. However, its author explained that PWC included projects with which PWC had been involved as advisor to either the public or private sector, excluded IT projects and included the first eight DBFO road schemes.<sup>1</sup> The report does not contain any supporting financial or other empirical data on service or volume levels.

A third widely cited report, authored by the IPPR (2001), the think tank with close relations with the Labour government, was sponsored by KPMG and other private sector companies with a vested interest in the use of private finance. It too used secondary, *ex ante* evidence. While the report had reservations about the use of PFI in health and education, it did endorse the turn to private finance.

As well as VFM, a PFI project must satisfy a second criterion, affordability, in order to proceed, an issue that has largely been ignored in both the appraisal process and the wider public debate. The Treasury has not required a consistent reporting methodology that clearly describes and presents all the operating costs that enables an assessment to be made of the affordability of the scheme. Studies of PFI in hospitals have shown that affordability was indeed a problem (Gaffney *et al.*, 1999 a,b,c; Pollock *et al.*, 1999; Froud and Shaoul, 2001). The high cost of PFI in capital terms meant that the first wave of PFI hospitals were 30% smaller than the ones they replaced as Trusts adjusted their plans downwards. The affordability gap was further reduced by subsidies from the Department of Health, land sales, a shift of resources within the local healthcare economy to the PFI hospital, and 'challenging performance targets' for the Trusts' reduced workforce. Thus, PFI comes at the expense of both capacity and access to healthcare. The emphasis on VFM has served to disguise the high cost of PFI and downplay the importance of affordability, which in turn raises questions about VFM.

In summary then, VFM is based upon a flawed appraisal methodology and process for projects in an increasingly concentrated market of powerful international players. While the watchdogs have been critical of the business case for PFI projects, the government has commissioned reports supporting PFI, from consultants with commercial interests in the development of the policy. As such, they do not constitute an independent unbiased source, one of the basic requirements for objectivity. But even accepting their findings, in the final analysis they all rest upon *expectations* or *estimates* of future VFM over the life of the project, and none of them address the second criterion, affordability, which the emphasis on VFM instead downplays.

## Operational issues

A number of issues have become apparent that have implications for VFM and accountability to the public. Firstly, as indicated earlier, projects often change quite substantially after the selection of the preferred bidder during negotiations to satisfy the requirements of the partners, including the financiers. The corollary is that the projects may look very different from those originally advertised, under conditions where the public sector is negotiating with only one 'preferred' bidder, thereby eliminating the competitive pressure. The resultant changes in the terms and conditions raise questions about the degree to which the public authority has complied with EU procurement rules, an issue of concern at the EU level, which will be discussed in chapter three.

Secondly, small schemes are unattractive to the private sector and have increased in scale to make them PFI-able. For example, the two £30m refurbishment schemes for the Swindon and Marlborough Hospital and the Walsgrave Hospital became two multi-million pound new builds. In the case of education, schemes consisting of 20 or more schools were bundled together to create a single scheme.

In recent years, there have been fewer but much larger deals as the Treasury believes that the minimum project value to deliver VFM is about £20m (Treasury, 2003). The government has established public sector procurement bodies such as Partnerships for Health, Partnerships for Schools and the Community Integrated Projects Model for regeneration projects, to work with local public sector managers to bring together and make PFI-able a range of smaller projects within an area. It has developed new forms of PPPs, particularly in regeneration, that span several departments to provide improved social amenities, leisure, transport and housing in impoverished areas, where the public sector owns at least part of the assets and thus shares in the enhanced real estate values within the regenerated area. Under such a scheme, several local authorities bid for resources provided by several departments.

The government intends that there will be 20 such cross service PFI projects, as part of its Sustainable Community Initiative. But as yet, local authorities have been reluctant to provide the transport and social infrastructure necessary to support the affordable housing requirement of the Sustainable Community areas such as the Thames Gateway (NAO, 2007b). Such large schemes necessarily mean that the private sector has ever more control over public infrastructure, while multiple public sector partners may make such projects more difficult to manage.

Thirdly, there has been contract drift. A study into the cost of the first 12 operational PFI hospitals in England as of 2001, found that within four years of becoming fully operational, actual payments to the private sector turned out to be on average 20% higher than originally reported to the Health Select Committee (2000). The increases were as much as 71% for North Durham, 60% for South Manchester and 53% for Bromley (Shaoul *et al.*, 2008). While this may be due to volume increases, inflation, contract changes and failure to identify and/or specify the requirements in sufficient detail, such contract drift suggests, at the very least, that there will be further increases in the future and that the total cost of the projects will therefore be very much more than that predicted at financial close.

Further payment drift is built into the contracts since an important contractual feature of PFI is the ability of the SPV to rebase the service costs, due to the high labour content, at prescribed intervals during the contract when services are market tested and/or benchmarked. This goes some way to limiting the risk of any one service provider under pricing a service contract and/or limiting the exposure of the SPV to higher service charges from a subcontractor before being able to reset the cost of that service and reset the unitary payment. But the corollary is the increased cost for the procuring agency. While the Treasury has produced guidance for benchmarking and market testing (2006b), the NAO reported (2007c) that price changes in seven projects had ranged from -2% to +6% with the exception of one which was 14% and the VFM

of the completed value tests was uncertain in eight of the 16 projects it examined. The PAC's view was that, far from improving prices for the public sector, benchmarking and market testing had served to increase prices. It said that:

*The early experiences of these value tests show that PFI contractors are using these processes to secure price increases and that some authorities are cutting services to pay for them. (PAC, 2007, p.3)*

Portering services in hospitals were cited as an example.

Fourthly, it may be difficult for the public sector to ensure satisfactory delivery of contracted services via the system of penalties set out in the contract. The size of the penalties relative to the baseline payment below which the total payment cannot fall is not generally disclosed. One hospital for example reported that maximum deduction for poor service delivery was £100,000 on expected annual payments of £15m (Edwards *et al.*, 2004), which provides little effective sanction. Anecdotal evidence suggests that the scale of the penalties elsewhere while larger is, relative to the annual payments, small. There have been numerous adverse press reports in the UK of poor service delivery in hospitals under the contract, some of which are documented in evidence to the Health Select Committee (2002), and similar press reports of concerns about poor performance in schools projects. Metronet, which holds the contracts for two of the three London Underground PPPs, has been heavily criticised by London Transport and the Office of Rail Regulation for failing to meet the targets set for investment and maintenance. It is reported to have overspent by nearly £1bn only four years into its initial seven and a half year contract 'due to not working economically, efficiently or in line with industry best practice'. Nevertheless, according to the credit ratings

agency Standard and Poor's (2003), there have been few deductions in PPP contracts and these have been small, in part at least because of the complexity of the contracts that have proved difficult in practice to enforce. A case study of an NHS Trust found that monitoring has turned out to be more costly than anticipated, performance indicators have been difficult to operationalise, due to the subjective nature of the outcome, and contract changes have been time consuming and complex (Edwards *et al.*, 2004).

A report on prison performance noted that prisoners were confined to their rooms for longer periods and that their cells contained 'substantial ligature points' that 'rendered the cells unfit for use at all' (Chief Inspector of Prisons, 2000). HMP Altcourse at Fazakerley, the first PFI prison, was controversial from the start because of its poor planning, lack of scrutiny of costs, a flawed savings assessment, operational performance failures and lastly the refinancing scandal that saw the private sector refinance the deal in a way that generated an extra £11m for itself while at the same time increasing the risk to the public sector (NAO, 2000b). The NAO, in its investigation into PFI prison performance, reported that operational performance against contract had been mixed (NAO, 2003a).

As is almost universally accepted, operational performance has been conspicuously poor in IT projects, and the payment mechanisms have failed to incentivise the contractor. Even where penalties could have been invoked, these were waived in the interest of good partnership working and/or not jeopardising the policy, as in the case of the Passport Agency (NAO, 1999b) and NIRS2 projects (Edwards and Shaoul, 2003). Indeed, the outcomes of IT projects in the benefits recording and payments systems, the criminal justice system and other administrative services have been so poor that even the government has had to admit that PFI may not be the best means of procuring IT services (Treasury, 2003), and PFI for IT has now been abandoned. Taken together, such evidence as exists suggests the scale of the penalties, the complexity of

the contracts and the relative power of the partners may not provide the incentives that PFI's proponents claim, while simultaneously imposing additional costs on the public sector.

Fifthly, with 70% of PPP projects financed by bank loans (as opposed to bonds), some of the early projects have refinanced their bank debt with larger loans, generating large gains for the private sector (NAO, 2002b; 2006b). While the Treasury has issued Guidance on how the public sector should evaluate refinancing proposals, it is not opposed to refinancing (2005a). Its guidance implies the need to audit the private sector's financial models in relation to refinancing (Treasury Task Force, 1999a; Treasury, 2004). There is however no evidence that such audits have been conducted and any sanctions implemented.

But such refinancing not only raises concerns about whether the original risk transfer was over-priced, but also increases the companies' financial risk, negating the perceived lower business risk following construction and leading in some cases to credit down rating, as Standard and Poor's point out (2005). Thus while this may be good for the parent companies in that it releases cash, this may not be a prudent decision for the SPV and this in turn has implications for the public authority, which incurs additional risk.

As the NAO pointed out in its report on the Darent Valley hospital project (2005), the refinancing increased the project's internal rate of return for the company from 23% to 56%. The Trust's share of the refinancing, 35% of the £34m gain on a negotiated pre-guidance basis, left it only £8.5m better off than before refinancing. Similarly, the refinancing of the Norfolk and Norwich hospital provided a £115m gain by increasing the SPV's borrowings from £200m to £306m. While the company voluntarily handed back £30m of the gain, this still increased the internal rate of return from 16% to 60%. Even more importantly, the refinancing of the now higher debt meant that it would be phased over a longer period, entailing a contract extension from 30 to 60 years. As well as the concomitant cost that flows from such a doubling of the contract life, there are additional risks. Should the contract be terminated

for whatever reason, the Trust would have to take over the new debt, which is higher than the value of the hospital, thereby increasing its own costs, under conditions where the parent companies have taken the gains. All this stands in contrast to a prudent government agency which could have used the opportunity to reduce not increase debt.

Sixthly, the adverse publicity from the NAO and PAC reports has led to few refinancing deals, with only 42 of the 670 completed projects being refinanced by 2005. However, an alternative and quicker route to release the gains from PPP deals is increasingly being achieved by the sale of equity stakes. Post construction, some equity partners have sold their stakes in a rapidly emerging secondary market, particularly the construction partners, making considerable gains on their original investment (NAO, 2006b), again raising concerns about whether the original risk transfer was over-priced. By 2005, over £700m of equity stakes had been traded, although it is far from clear whether this is in fact a complete total (DLA Piper, 2006).

One group of secondary investors include institutions seeking long dated cash flows against pension liabilities: PFI stakes, with their guaranteed revenue streams, appear to offer secure returns to pension funds. Specialist secondary funds have been set up to buy 100% of the equity of operational projects, becoming active asset class managers, specialising in specific sectors. These include the Secondary Market Infrastructure Fund, Innisfree M&G PPP Fund, Henderson Investors plc and Infrastructure Investors. Some of these have been primary investors. Such funds have no relationship with the service providers other than the subcontractor relationship and thus have an incentive to drive down their subcontractors' prices. Some funds have acquired minority interests as passive partners. Thus, PPP provides a mechanism whereby public services become integrated into the broader international economy, and international corporations are becoming specialist providers of schools, hospitals, prisons and roads.

Seventh, numerous PFI/PPP market reports have commented on the high cost of bidding for PFI/PPP contracts, including the development,

funding and advisory costs that do not vary proportionately with the size of the deal. This has led to the PPP market becoming highly concentrated and confined to the large firms (Ekene *et al.*, 1997). Furthermore, Ekene *et al.* found that while many of the large contractors initially bid for several contracts, they were becoming more selective as to the projects they would bid for and some of the contractors would only bid for projects that they were confident of winning. Furthermore, some of the contractors were partners or subcontractors in more than one bid.

The UK market is split between: (i) the international contractors: American, French, Spanish, German, Dutch and Scandinavian; (ii) international UK contractors; and (iii) domestic UK contractors. All three groups are looking to expand within their own home market as well as internationally, and within the UK all are focused on the Thames Gateway regeneration/Olympics PPPs.

Of the 98 projects on the PUK database with information about the construction partners in May 2006, Balfour Beatty won 22 with a capital value of £2.4bn, Carillion won 14 projects (£2.1bn), Amec won 11 (£1.9bn) and Alfred McAlpine won 12 worth £1.1bn. This raises questions not only about the competitive pressure at the procurement stage but also about the relative power of the partners in the ensuing relationship and the ability of the public sector to enforce the required standards of performance. A report by the NAO (2007a) drew attention to the fact that the number of bidders had declined, with two or three bidders being the norm compared with five to seven a few years ago. This means that the contractors are now in a position to exert the monopoly power that undermines the VFM argument and thus to control the direction of future policy. A recent statement from the Office of Fair Trading (2008) alleged collusion between 112 large construction companies via a practice known as 'cover pricing', where a contractor consults with a competitor during a tender process to ensure that the price it submits is too high to win.

The market for financial advice is even more concentrated, with the international Big Four accounting for most of the work. PwC was by far the most frequent advisor to the public sector, acting on more than half of the deals: 160 projects with a capital value of £26bn. Deloitte and KPMG advised on 40 and 35 deals respectively. The technical advisory market is similarly concentrated, with Ove Arup, Halcrow, Mott MacDonald and W S Atkins accounting for more than half. The same firms also advise the private sector, albeit on different deals. Under such conditions, conflicts of interest abound.

Finally, a number of commentators have pointed to the lack of reporting, disclosure and transparency relating to both the procurement decision, the operation and refinancing of these deals by the various parties (Heald and Geaghan, 1997, Edwards *et al.*, 2004, Hood *et al.*, 2006). This serves to increase public scepticism towards the policy and limit accountability to the public.

## PPPs in UK roads

Not only was the UK one of the first countries to turn to private finance for infrastructure projects, the DoT was the first department to use it to any significant degree. The first privately financed projects, signed between 1985 and 1992, included the Channel Tunnel, the Queen Elizabeth II toll bridge over the Thames at Dartford, the Second Severn Bridge, the Skye Bridge and the M6 Toll Road, Britain's first ever privately owned inland toll motorway. All of these were new builds, usually privately owned, and were to be privately managed with user charges. Since tolling required primary legislation for each project to be enacted, the government introduced the 1990 *New Road and Street Works Act*. This gave the Secretary of State for Transport, that is, central rather than local government, the power to initiate new roads and bridges and to charge users directly for new, but not existing, roads and bridges. This represented a major change at the time because although a handful of bridges and tunnels owned by local authorities were tolled, those run

by central government were free. The Labour government has taken these developments a step further by introducing legislation that allows local authorities to charge road users directly for existing roads through the use of a congestion charge.

The Conservative government then extended the policy to existing roads via DBFO for the main trunk network whereby the private sector would extend or enhance a road to the department's requirements, operate and maintain it for a 30 year period. The 30 year period was chosen because the payment mechanism had to enable the debt finance, which typically has a repayment period of 20 years, to be repaid and ensure a return to the equity investors.

Instead of direct tolls, the government would pay the contractor on the basis of a shadow toll, despite the fact that the Conservative government's Green Paper (DoT, 1989) had explicitly ruled out shadow tolls. The system of shadow tolls was designed by the government's advisors, Price Waterhouse, to allay the private sector's fears that direct tolls would – as experience elsewhere had shown – arouse political opposition thereby endangering the policy of creating a private road-operating industry (Glaister *et al.*, 1997). Payments would be based on the number of vehicle kilometres travelled by short vehicles (cars) and long vehicles (heavy goods vehicles), in a series of bands, which would be capped at a certain level. Shadow tolls were seen as a precursor for tolling (DoT, 1993).

The procurement process for the first eight DBFOs in England took place over a protracted period between 1993 and 1996 with a further one in Scotland, making a total of nine DBFO projects signed by the Conservative government by 1997. Since then, more recent schemes have moved away from payment mechanisms focused entirely on shadow tolls to some element based upon road availability to encourage efficient operations, performance, safety and congestion management payment mechanisms. Such mechanisms therefore avoid transferring demand risk, something that the private sector cannot control.

Table 2.1, compiled from various sources, shows that 23 deals with a capital value of about £3bn had been signed by the end of 2006, about 35% of total new road construction. The government's national 10 year transport plan, '*Transport 2010*' (DETR, 2000), allocated £21bn to the strategic highway network, 25% of which will involve private finance and will be targeted on motorway widening contracts rather than further road construction or maintenance. Three major motorway expansion schemes, the M25 widening and M6 and M1 upgrade, each worth about £1.5bn, are currently under consideration for DBFO or some other form of private finance. Another likely project is the Thames Gateway Bridge valued at £450m, a new eight lane toll crossing in East London, designed to open up the Thames Gateway regeneration zone on either side of the Thames. But with 20% of the Highways Agency's budget already committed for 8% of the network, and the M25 DBFO project estimated at a further 20% of the budget, according to a Highways Agency official (Taylor, 2005), these projects must, in the absence of additional funding, come at the expense of the rest of other investment and maintenance. In a related development, the government has announced road user charging, both pilot congestion charging projects in cities that will get some central government funding from the Transport Innovation Fund, and nationally, which are expected to be operated by the private sector.

*Table 2.1 Privately financed road projects in the UK*

Public authority	Type of concession	Number of concessions	Capital value
Highways Agency	DBFO	10	£908m
Highways Agency	Free standing with user tolls	3	£996m This includes the M6 Toll Road which is valued here at £485m although other sources range from £680-900m.
Scottish Office/ Executive and agencies	DBFO	4	£264m
Scottish Office/ Executive	Free standing with user tolls, with contribution from the public sector for the infrastructure and later the tolls	1	£24m + £15m from public sector
Welsh Office/ Assembly/ Development Agency	DBFO	2	£147m
Local authorities	DBFO	2	£211m
Transport for London	DBFO	1	£485m Although sources are variously £128m, £146m and £411m
<b>Total</b>		<b>23</b>	<b>£2,961m</b>

Sources: Highways Agency, Scottish Executive, Transport for London, Treasury database of PFI statistics, National Audit Office, various years.

There is as yet little empirical financial evidence as to how these projects are working out in practice. An *ex post facto* study of the cost of using private finance for the first eight DBFO roads commissioned by the Highways Agency, generally believed to be a success, and paid for through a system of shadow tolls, found that publicly available financial information about the schemes from both the public and private sector partners was limited and opaque (Shaoul *et al.*, 2006). In the early years, they were not reported at all. In subsequent years, it was impossible to isolate the costs of individual projects. In the first three years that they were reported, the Agency paid more than the construction costs. It was unclear whether the payments were higher than expected at financial close. Its private sector partners reported a post tax return on capital of 29% and an effective cost of capital of 11% in 2002, twice the cost of public finance. The difference between the cost of public and private finance is attributed to the risk premium or the cost of risk transfer. This underestimates the total cost of capital since the SPVs, by operating through a complex web of subcontracting, create additional, undisclosed sources of profit for their parent companies that make it difficult to establish the total cost of using private finance.

But there is a lack of transparency about the risks actually carried which makes it impossible to know whether the rewards are commensurate with the returns. While the additional cost of private over public finance is attributable *ex ante* to the cost of risk transfer, it was difficult to see, given that the contracts involved roads that had already been designed and gone through all the planning stages, thereby reducing some of the main risks, how such a high 'risk premium' could be justified (Shaoul *et al.*, 2007b). Indeed, according to the credit ratings agency Standard and Poor's, the Highways Agency's 'obligations were directly guaranteed by the government' (2003, p.9).

Furthermore, while the revenue streams appear to have been front loaded, there was no ring fencing of the surplus needed for major maintenance work in the future. In one case, the SPV had obtained

a loan whose proceeds were passed to the parent companies for an indefinite period on an interest free basis. This lack of ring fencing creates risk for the taxpayer, who may be faced with paying a second time for maintenance, if for any reason the private sector is unable to pay.

Such research findings are important because they point to the need for much greater disclosure about all aspects of the deals and for clarity about the risk transfer and the form of government support, both explicit and implicit, and the disparity in the disclosure to the financial markets and to the public at large.

## **Developing a reporting framework**

The procurement process, the issues highlighted in this research literature, and the National Audit Office's evaluative approach to PFI (NAO, 2006a) provide the basis for drawing up a list of the types of information that need to be disclosed from an accountability perspective. These include the decision-making process at the time of procurement, the contractual arrangements, the content and form of the annual reporting by all the parties involved, and the arrangements at contract termination. Such information is grouped under six headings on the basis of their occurrence in the PPP process and potential purpose, as shown in Table 2.2, and includes:

- The strategic business case that sets out clearly the costs and benefits of the project and clearly demonstrates the need for the project, and why it should proceed;
- The documents relating to the tendering, bidding and selection of the preferred bidder, to demonstrate the competitive pressure necessary for both probity and VFM;
- The financial appraisal or business case that shows the PSC, and clearly demonstrates the case for private over public finance, its VFM, the risks to be transferred, and its affordability;

- The contractual documents that show the terms and conditions, particularly any guarantees, payments, penalties for poor performance, the arrangements for monitoring, changing and terminating the contract, and that these accurately reflect the financial case for private finance, including the risk transfer;
- The annual reporting by:
  - o The public authority/ies showing the annual costs, performance of the project and private sector partners, risk allocation, own monitoring costs and any changes in the contractual arrangements, scrutiny of this reporting, any formative evaluations, guarantees and contingent liabilities. Such information is important for monitoring the contract, market testing at five yearly intervals, and contract amendments and renegotiation during the life of a 30 year project, if it is to deliver VFM.
  - o Similar reporting by the private partner including contingent liabilities and where payments from the public sector have been frontloaded, evidence that such funds have been ring fenced against future costs. The public and shareholders have an interest in understanding the source of the company's profits (or losses), and future prospects.
- The financial and handover arrangements for any completed projects, including a summative evaluation.

This information, most of which is routinely prepared and collated for managerial purposes, needs to be routinely published in way that is accessible to the public. With the advent of the internet, such documents can now be published at negligible cost on the relevant partners' websites.

Table 2.2 Recommended reporting framework

	Stage	Purpose of information
1	Strategic analysis/ economic appraisal	Strategic economic case demonstrating need and cost benefit analysis.
2	Competitive process	Bidding arrangements to ensure competitive process and market price.
3	Financial appraisal at financial close	Financial case for private finance, including VFM and risk transfer, the public sector comparator and any other alternatives, and affordability, to show that only good projects proceed. Any <i>ad hoc</i> scrutiny reports.
4	Contract documentation	The contract documents that clearly show that the terms of the deal and the financial arrangements in the case for private finance are reflected in the contract arrangements.
5a	Annual disclosure/ scrutiny including <i>ex post</i> information re VFM, costs, performance, affordability – public sector	Reporting to show how the project is working out in practice in relation to financial and physical performance, the actual risk allocation, any contingent liabilities and guarantees, and affordability. Evidence about any formative evaluation/review by the public authority and annual scrutiny of or <i>ad hoc</i> reports by the official watchdogs. Evidence of any scrutiny by the public agency of the private partners' financial costs and position.
5b	Annual disclosure/ scrutiny of costs and performance – private sector	Reporting to show the financial costs and the viability of the project and the company, including any ring fencing of the surplus. Evidence about the performance of the private sector from any formative evaluation/review by the public authority and annual scrutiny of or <i>ad hoc</i> reports by the official watchdogs.
6	Termination/renewal	Information to show the financial arrangements, the condition of the asset, winding up arrangements of the private partner, any summative evaluation, including any external review.

## Summary

By focusing on the process and practice of PPP development, this brief review has shown the increasing role that the private sector plays in the delivery of services via PPPs and in the control of the policy, its direction and management. The requirement to make schemes financially attractive to the private sector has resulted in projects that are larger than originally intended; the bundling together of multiple relatively small projects for one public authority; and the bundling together of projects for several authorities. This has the potential to distort the planning and decision making process, make the management of and the accountability for such projects more complex, and has served to limit the number of potential contractors to the large international corporations.

This review has highlighted the importance, as the legal consultants DLA Piper (2004) noted, of the fourth P, politics, in getting PPPs off the ground. Financial consultants play a key role in devising the policy, ensuring that the projects would be financially attractive to the private sector, developing and vetting projects and in some cases are equity owners or major subcontractors. The increasing role of the private sector and financial consultants in policy formation and implementation and service delivery creates conflicts of interest. This has all the greater significance in that this is not a policy that was initiated by the public or has popular support, as even the policy's proponents recognise (IPPR, 2001).

Approval for projects depends upon an appraisal methodology and process that needs to demonstrate that they are VFM, economically sound and affordable to the procurers. The evidence shows that such projects are costly and are committing an ever greater proportion of public expenditure, and a very high proportion of the Highways Agency's budget in the future. This must create affordability problems for the commissioning agencies.

Some public authorities have experienced difficulties in obtaining the standard of service they had anticipated, a few projects have collapsed and had to be renegotiated and others have generated large rewards for their private sector partners via higher than expected profits, refinancing and the sale of equity stakes. These issues raise concerns about service specification in the contracts, contract enforceability, and the allocation of risks and rewards.

Since the anticipated VFM provides the rationalising motif for both the policy and individual projects, any evaluation of the actual merits of the policy needs to consider the financial costs in relation to project outcomes. Thus project and policy evaluation to inform future practice and policy choices requires the provision of useful financial and non-financial information and public access to such information from both the public authority and its private sector partner, as well as data relating to the performance of the private partners. From the perspective of this study and at a more general level, such information is also needed for the public to understand the costs of such projects and to judge the sustainability or otherwise of public expenditure.

This chapter has indicated that the true policy framework and practices differ from that set out formally in the law, regulations, concessions, licences and government budgets, and that the real distribution of risk falls more on taxpayers and users and less on the financiers than the apparent distribution. Furthermore, there are in effect implicit guarantees, including political support, and the cost and significance of these increases as the private sector's debt increases.

A reporting framework was therefore outlined that lists a range of information that needs to be put in the public domain. This includes information relating to the decision-making and procurement process, and the project itself, expanded annual reporting by the various parties involved, and what happens when the contracts come to an end.

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#### ENDNOTE

- 1 Personal communication with the authors of the report.

# 3 PPPs IN EUROPE

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## Introduction

While the UK is seen as the model for PPP type arrangements, the European Union (EU) has a significant role in relation to both transport in general and PPPs. The purpose of this chapter is to understand the role of the EU in the context of both transport and PPPs, chart the scale of PPPs in roads in Europe and the experience of Spain, the earliest and largest user of private finance for roads in Europe. The role of the EU as it relates to the reporting of PPPs is covered in chapter five.

This chapter briefly outlines the development of transport policy in the EU. With the move towards the Single Market in the late 1980s, transport policy increasingly came within the EU's remit. It encouraged the liberalisation and deregulation of transport and communications and the development of major arterial road and rail links to move both freight and people. It was in this context that PPPs began to be seen as a possible way of procuring the finance for the Trans-European Network (TEN) that some member states could not otherwise afford.

The chapter then reviews the development of PPP policy in the European Union, which while very supportive of the policy of using private finance, has been late to formulate an explicit policy on PPPs. Although not itself a major commissioner of PPP projects, the EU is both the overall market regulator and legislative body in terms of government procurement to ensure competition and transparency for the prospective contractors. It therefore increasingly determines the way that PPPs are commissioned and operate. The chapter outlines some of the regulatory issues posed by PPPs in relation to state aid, financing, the procurement process, first movers, subcontracting and competition, the classification

of PPPs for public expenditure purposes and the responses to the EU's Green Paper on PPPs.

The chapter charts the spread of PPPs in roads, which has required extensive political and financial support. It outlines the different levels of government support, payment mechanisms and ownership structures in the member states, and the key players in the PPP market. It then reviews the experience of Spain, the first country to use private finance for roads, which was not without problems. As PPPs are relatively new, there has as yet been little research in other countries that analyses or evaluates the implementation of the policy, as opposed to describing the procurement process.

## **The EU and transport policy**

As transport policy embraces a very wide range of issues, only those issues directly relevant to this study: the development, financing and ownership of transport infrastructure, are considered here.

The 1956 Spaak Report had drawn attention to three aspects of transport policy that would need to be covered by the founding Treaty of the European Economic Community (EEC), the precursor to the EU: non-discriminatory pricing, the development and financing of infrastructure investment, and the formulation of a common transport policy. But member states were so deeply divided that the Treaty was an awkward compromise and did not directly deal with transport policy, and such provisions as there were, Articles 70 and 71(1), the original Treaty as amended by the 1997 Treaty of Amsterdam and 2001 Treaty of Nice, were treated as though they exempted transport from the general liberal tenor of the Treaty.

It was only in the 1980s that the European Court of Justice brought transport more directly into the EEC's sphere of competence when it ruled that anti-competitive regulations applied to transport, thereby opening up transport to liberalisation and deregulation. A second

development was the 1987 Single European Act that introduced qualified majority voting to transport, one of the key areas where unanimity had proved to be an obstacle to the development of the single market. Since then, there have been deregulatory measures in all modes of transport that have paved the way for the break up and privatisation of state owned enterprises and new entrants to the transport market.

In the 1980s, the major European corporations lobbied for the expansion of large scale investment in transport as part of a broader policy of restructuring production in Europe and played a major role in placing TENs, which covered not just transport but energy and telecoms, on the political agenda. Several new Articles, now 154-6, were added to the 1991 Treaty on the European Union that provided for the development and financing of TENs. These gave the EEC power over cross border infrastructure. The Transport Network (TEN-T) that included high speed trains, waterways and airports as well as 12,000 km of new motorways was thus written into the Maastricht Treaty.

A semi-official High Level Panel on Private Finance for TEN-T was established. At the 1994 Essen Summit, the European Council adopted 14 major transport projects, mostly rail, as priority projects crucial to the development of the internal market, although they were largely to be funded nationally. It announced €4.2bn worth of funding in the form of capital grants for the seven years 2000-2006, and endorsed the calls from the industry for public private partnerships, thereby supporting private finance for such projects,

In 1996, the cost of the TEN-T projects was estimated at €400bn by 2010. But six years later, only 20% of the total TEN-T had been completed as costs escalated. At that rate, it would take 25 years to complete the network. The nature of EU aid, capital grants, and their small scale, were perceived as a limiting factor. The list of 14 priority developments was increased to 30 in 2004, again largely rail schemes, in the light of the *European Initiative for Growth* (EC 2003b).

In the context of other road schemes, further EU legislation in 1995-96 enabled the selection and financing of a substantial number of smaller projects, with the EU's poorer regions receiving substantial financial support from the EEC's regional and cohesion funds.

While the European Commission (EC) is supportive of PPPs, it concluded that they provided only a partial solution to the problem of financing transport infrastructure (EC 2003a). The Commission's proposals to expedite the projects included road tolling, measures to modernise the EU's procurement rules, guidance as to how to account for PPPs in national budgets and the development of a European guarantee instrument to be backed by the Commission and Member States (EC 2003b), issues which are discussed in the next section. PWC (2004a) called for the Commission to allow its funds to be used for 'availability payments' or recurrent expenditure as well as capital grants, arguing that this would permit the procurement of road and rail projects via a PPP structure, thereby leveraging in private finance in addition to public finance from member states.

## The EU and PPPs

Although historically the EU has been neutral as to the ownership of assets (Article 295 of the Treaty), having no policy on privatisation *per se*, since 1999, the European Commission's policy has been to increase the amount of private finance for infrastructure, particularly in the transport sector. It views PPPs as one mechanism for achieving several broader policy objectives: levering in private finance, avoiding fiscal constraints on public borrowing and improving the infrastructure. It is part of a wider push to regulate public markets so that they mimic private markets, eliminate procurement practices that favour national champions, and create an international market. It is also bound up with moves to open up and deregulate public services via the so-called Bolkestein Directive, first introduced in the European Parliament in February 2006. But

while the EU has embraced the liberalisation agenda, there is as yet no EU PPP policy as there is in the UK.

The Council of Ministers endorsed the use of the PPP mechanism at their meeting in December 2003 and the EU is supportive of PPPs in certain areas. For example, the European Council called on the EC to 'explore how best to mobilise private financing support of the *European Initiative for Growth* and consider how best to promote PPPs'. The *European Initiative for Growth* (EC 2003b) called for the creation of 'the right regulatory, financial and administrative conditions to boost private investment' and 'the refocusing of public expenditure towards growth enhancing areas without increasing public budgets'. Thus partnerships were seen as a way of boosting investment without increasing public debt, thereby fulfilling political and macro-economic objectives, the additionality argument.

There have been a number of EU statements and reviews concerning PPPs, these are listed in Table 3.1. Many of them relate to PPPs in the context of transport, particularly the TEN-T programme, in part at least because it has a budget allocation, albeit small in relation to the programme. The *van Miert Report* called for more use to be made of PPPs for this purpose and for the expansion and the development of PPPs and the regulation of public contracts through Community law (EC 2003c). Others have sought to facilitate PPPs in new member states and accession countries so that grants for environmental and transport projects would be available for PPPs (PWC 2004b).

*Table 3.1 EU policy documents and initiatives relating to PPPs 1993 to date*

Date	Reports	Source
1993	White Paper on growth, competitiveness and employment	Com(93) 700
1997	High level Group on PPP financing of TEN-T projects (known as the Kinnock report)	Com (97) 453
2000	Commission's Interpretative Communication on Concessions under Community Law	OJEC (2000/C 121/02)
2000	Proposal for a Regulation of the Council and Parliament concerning the granting of aid for the coordination of transport by rail, road and inland waterways	COM (2000) 5
2001	White Paper on European transport Policy for 2010: time to decide	COM (2001) 0370
2003	Guidelines for successful public private partnerships – DG Regio and dissemination at a series of international conferences	DG Regional Policy 2003
2003	A European Initiative for Growth – Investing in Networks and Knowledge for Growth and Jobs	COM (2003) 690
2003	Communication from the Commission: developing the trans-European transport network: innovative funding solutions and Proposal for a Directive on the widespread introduction and Interoperability of Electronic toll collection systems	COM (2003) 132
2003	High Level Group Report on the TEN-T network (known as the Miert report)	DG Transport (2003)
2004	Eurostat proposals on accounting treatment of PPPs	CMFB and Eurostat news release (STAT/04/18) February 2004
2004	Green Paper – EU consultative paper on PPPs and Community Law on Public Contracts and Concessions	COM (2004) 27 May 2004
2004	Resource book on PPP case studies	DG Regio June 2004

Notes:

DG Regio is the Directorate-Generale Regional Policy

COM is the series reference for documents produced by the European Commission

OJEC is the Official Journal of the European Communities, now renamed the Official Journal of the European Union

CMFB is the Committee on Monetary, Financial and Balance of Payments Statistics

But EU procurement law, which follows the framework for public procurement procedures provided by the *Agreement on Government Procurement*, administered by the World Trade Organisation to which most countries are signatories, does not define PPPs. Nor does EU law provide a specific set of rules governing the procurement of PPP projects. Indeed, with the wide range of arrangements that fall under the PPP umbrella, 'a specific PPP directive would be difficult to formulate and even harder to apply' (Economic and Social Committee 1998: para 5.1.2).

There is therefore a good deal of uncertainty about the compatibility of European public procurement rules and PPPs, which has not been clarified by the European Commission. This uncertainty relates to the contractual nature of the privately financed project from the perspective of EU procurement law and the types of procedures to be used for awarding contracts,

PFI or contractual models where the public agency pays the private partner may be either a public services or a public works contract depending upon the intention of the public authority, the contract's specification and the ownership of the underlying asset. While the intention is usually to procure services, the lack of contract specificity which typifies PFI projects leads to negotiations with the preferred bidder prior to financial close that change the nature of the deal and raises questions about the VFM and legality of its procurement process. If the asset is to be owned by the public authority, then this is likely to form the basis of a public works contract. If on the other hand, it is to be owned by the private contractor, then the deal is likely to be a public services contract. The classification of the deal as either a public services or public works contract determines the procurement route. If it is a services contract, then there is a lower threshold for advertising the contract and the public authority may proceed under the more flexible negotiated procedure. A public works contract on the other hand has a much higher threshold for advertising, but must use the restricted procedure and is excluded from using the negotiated procedure.

The case when the public authority awards a contract or concession, often known as a free standing project, where there are user charges, is a grey area with inconsistent treatment for the two different types of concessions. A public works concession above a certain threshold is subject to the Public Works Directive. But public service concessions, which typically relate to more politically sensitive services, were excluded from the Public Services Directive and thus fall outside the remit of EU public procurement rules.

PWC (2004b), one of the major proponents of the policy, called for: greater certainty about EU rules on procurement and funding in relation to PPPs; the funding by the EU of specially created PPP units; and a central task force to assist member states, like the UK's PUK, in creating the institutional capacity to negotiate such deals. It emphasised the importance of clarifying existing rules as they relate to PPPs over developing new ones.

Notwithstanding the definitional issues surrounding PPPs, the Commission's desire to extend the private sector's role in the delivery of public services means that it has had to address a range of key issues, including:

- The need to clarify public procurement rules for PPPs in the context of complex negotiations and state guarantees;
- The procurement rules for concessions, the oldest form of PPPs in Europe;
- Clarity over the issue of state aid and PPP;
- The need to develop new financing instruments, support for PPPs at EU level and institutional capacity for PPPs in the public sector;
- The need for clear rules governing the life of the contract, which can be expected to change over time and therefore opens up questions about the necessity of reopening a competitive bidding process; and

- The need for a clear and consistent framework, including how they should be accounted for in both the annual accounts and national budgets.

The Commission therefore issued a consultative Green Paper (EC 2004) to examine these and other issues and to seek views of the industry on whether it was necessary to improve EU law in this area. In the event, the Green Paper dealt largely with PFI or contractual arrangements rather than concessions and joint ventures, and thus did not resolve a number of issues. Furthermore, it was pre-empted by comprehensive Directives on public procurement published one month earlier, whose aims were to open up national public procurement markets in the EU to other member states, with the result that the Green Paper has now lapsed.

Each of these key issues as they relate to this research, some of the issues raised by the Green Paper and the response to the Green Paper are discussed in turn, in order to understand the direction of the EU's thinking on PPPs.

## **Procurement rules**

As explained earlier, the type of PPP arrangements: contractual, co-ownership and those that do not fall into either category determine which procurement rules apply. PPPs that qualify as public contracts are subject to the detailed provisions of the Procurement Directive. While most PPPs fall within this regime, some do not, including: service only concessions, which must follow the negotiated procedure arrangements; joint ventures and privatisations; defence contracts; and some explicitly exempt services such as training. Within the UK, public authorities also have UK public law obligations, to act fairly, reasonably and take into account relevant considerations, and if they act outside these restrictions they are open to judicial review.

There are basically two types of procurement procedures for public service contracts, the negotiated procedure and competitive dialogue. Under Article 30, the negotiated procedure (as opposed to the restricted procedure used for clearly defined commodities as in public works contracts), is used for large contracts awarded by public authorities where the nature of the services, the risks and scale are such that it is not feasible to draw up exact specifications to allow prior pricing. It is the required route for service only concessions. It is by far the most common method of PFI procurement in the UK. The negotiated procedure is divided into stages: an initial pre-qualification stage concerned with the technical, managerial and financial resources of the bidders; the invitation to submit proposals (an intermediate stage for very large projects); the invitation to tender; and finally the selection of preferred bidder. However, as shown earlier, some negotiation frequently takes place after the selection of the preferred bidder.

Article 29 of the Procurement Directive therefore introduced the competitive dialogue procedure, a new procedure designed for PFI-type contracts in order to restrict the widespread use of the negotiated procedure for major projects in some member states, particularly for large DBFO projects. It does not however explicitly restrict the use of the negotiated procedure to situations where competitive dialogue is not available. Under the competitive dialogue procedure, the public authority discusses the form of the contract and the potential specification with potential bidders, possibly in successive stages, before the key tender documents are issued. Once the tender documents have been finalised based on those discussions, the dialogue is closed and the bidders base their proposals on them. The contract is awarded to the most economically advantageous tender without any further negotiations.

The competitive dialogue is therefore less flexible than the negotiated procedure, since negotiations can only take place during the early stages of the process. But since the bidders are unwilling to incur the costs for technical, legal and financial due diligence, lenders are usually

unwilling to complete due diligence in the early stages of the process. It has therefore been standard practice in PFI procurement to make adjustments after due diligence has been completed to provide comfort to the lenders, although this has on occasion meant substantial revisions to projects. This has generated considerable controversy, particularly in the UK where this practice is prevalent. In a number of high profile UK cases, the final project differed from that originally advertised. It would therefore seem that the procedure would not after all preclude further negotiation after selection of the bidder. That is, the issue of contractual changes during the life of a project has not been resolved.

Furthermore, while contracts include mechanisms for handling minor changes, there have been concerns that there have been major modifications leading to a new or extended contract that has gone to the existing contractor under conditions where the competitive pressure had been lost.

The Green Paper considers that any contract changes:

*...have the effect of calling into question the principle of equality of treatment of economic operators. (EC 2004)*

It proposes that any substantial modification should be considered as a new contract and therefore subject to a new round of competition. While such contractual changes provide an opportunity for the private sector to take advantage of their 'monopolistic' position as sole supplier, since the public sector is essentially 'locked in' (Lonsdale 2005), the Green Paper's proposal is unlikely to be a practicable solution for either party, as the renegotiation of the NIRS2 contract illustrated (Edwards and Shaoul, 2003). Furthermore, it is likely to deter the private sector from agreeing contracts if every substantive change had to be re-tendered.

The Green Paper points out that secondary legislation lays down the exceptional circumstances that would permit additional works or services

without competition, but insists that such exceptions be interpreted restrictively. It specifically cites the example of extending a motorway concession to cover the cost of completing a new section, as has occurred in Spain, and warned against the practice of combining profitable and non-profitable activities so that a new activity is awarded to an existing concessionaire without competition.

### **PPPs and state aid**

The EU generally prohibits state aid to private enterprises except under tightly defined conditions such as: support for underdeveloped regions; the promotion of a project of common European interest; restructuring; and to pay for externalities. If public subvention does not satisfy these conditions, then it constitutes state aid and any subsidies must be refunded and the enforceability of any guarantees is uncertain. As yet the issue of state aid and PPPs has not been a major issue. But if financing structures are developed that include state aid and/or European grant financing, then there would be a need to ensure compatibility between PPPs and state aid rules. Where there is a competitive tender process, the scope for legal challenges under the state aid rules is limited. However, where the negotiated procedure is used, should there be alterations to the contract after the selection of the preferred bidder, there is a risk of a legal challenge.

In 2002, the Commission made one of the few rulings on the issue, in the context of the London Underground PPPs. Here the government, which had originally expected to terminate all grants to London Underground, had announced a grant to cover the cost of investment under the PPP and that the private sector debt would be guaranteed, after selection of the preferred bidders. The Commission ruled that that this grant did not constitute state aid and thus the PPP contracts did not breach EU rules. It confirmed the principle that the state should pay for any externalities. Its decision appears to imply that complex

infrastructure projects can be awarded after extended tender procedures involving alterations to the contracts and government grants and after the appointment of the preferred bidder, without automatically constituting state aid and thus potentially an unfair advantage. The Commission found that public procurement rules had been followed; and that the maximum potential transfer of value to the bidder was reasonable for contracts of this type. In addition, it found that that the combination of the continuous review process, the arrangements for subcontracting by competitive tender, the commercial incentives built into the contract, and London Underground's audit rights served to limit the payment mechanism departing from the market price in future years.

It is possible that this issue could become more important in future PPPs. Should the state aid rules be breached, the consequences could be serious for the private sector. If the payment mechanism is deemed to be too generous, then the government could be ordered to reclaim the excess. Perhaps even more importantly, any state guarantees, on which financiers may be relying, may be unenforceable.

### **PPPs and financing instruments**

In order to develop the use of private finance in major infrastructure projects, it is argued that there is a need for the EU to develop additional financing mechanisms. The European Investment Bank (EIB), funded by member states and accountable to the European Parliament, has played a major role in promoting PPPs by providing finance for PPPs and particularly transport projects, and developing new financial instruments and initiatives. Furthermore, it is represented on various bodies concerned with PPP issues. The EIB, which lends at lower rates than commercial banks, serves to reduce the cost of borrowing, a benefit that has not always been passed on to the public authority (EIB 2005), and its approval facilitates additional loans elsewhere in the financial

market. In effect, this permits public sector credit with private sector returns.

The *European Initiative for Growth* (EC 2003b) lists several instruments which the Commission believes are relevant here:

- The provision of third party equity or quasi equity alongside grant aids and contributions from the public authorities. For example, under the TENs Financial Regulation, some of the budget may be used for equity or quasi equity investments in projects;
- Securitisation;
- The EIB's Structured Finance Facility which contributes to the provision of debt finance for the early, pre-construction stages of projects; and
- The European Guarantee Instrument to cover specific risks in TENS projects in their post construction phase.

But it is far from clear that the lack of finance for PPPs is a problem. Shortage of finance has not generally been a problem as purchasers, such as pension funds, view PPP projects as quasi government debt that meets their needs for long term investment. In addition, a number of European banks are buying low rated PPP debt to balance their high risk debt. Where the projects are structured in ways that make it attractive to the private sector and are affordable to the public sector, then finance has usually been forthcoming. In other words, the broader political support for the project, including public contributions, are crucial for determining its financing, not the lack of institutions willing to lend.

More importantly, the financial sector has sought to mitigate its risk by securing explicit or implicit guarantees from government and/or purchasing government backed securities. In this context, it is worth noting that the UK government has introduced a Credit Guarantee

Facility (CGF) (Treasury, 2003), whereby the roles of financing and risk taking are separated in an attempt to cut the cost of finance by 5-10%. Under CGF, the government issues bonds at lower cost on the gilt market and passes them onto the project company at market rate. In order to mitigate risk, the government takes a guarantee of repayment from a commercial institution such as a bank or monoline provider. As yet, however, few UK PPPs have been financed in this way.

### **First movers**

The issue of first movers or unsolicited proposals has been another contentious issue. The Green Paper supports proposals that 'first movers' should have some privileged treatment to maintain the incentive to initiate proposals for public spending on their projects. But such proposals enable extra contracts or less competitive contracts and create the potential for both corruption and higher costs for the public authority since they preclude the evaluation of alternatives. Many of the world's most controversial private infrastructure projects originated as unsolicited proposals to governments leading to 'many negative experiences' as the World Bank has noted (Hodges, 2003).

### **Subcontracting and compulsory competitive tendering**

Since, under current rules, the main contractor is not required to submit all of its contracts to competitive tendering, many project companies subcontract to their sister companies, the usual practice in UK PPPs. The Green Paper recommends that the prime contractor should be required to submit all of its contracts to compulsory competitive tendering. Although this is not required in the UK, it is worth noting that London Underground did demand that Metronet, one of the London Underground PPP companies before its demise, put out all its subcontracting to tender in an attempt to rein in its projected £2bn

overspend. In the event, however, Metronet collapsed before this was implemented.

The Green Paper also calls for compulsory competitive tendering when the public authority contracts with an arms-length public company or corporatised public body. This would therefore widen the scope of PPPs to include arrangements that include operators that are public enterprises not belonging to the general government sector, so called 'project vehicles' and in effect provide a mechanism for increasing external outsourcing.

### **The classification of PPPs for public expenditure purposes**

A key motive for PPPs has been the desire on the part of governments to evade the EU's fiscal constraints that limit the amount of public debt. The private sector also supported this as it believed that it would encourage the turn to private finance. In this context, PWC (2004a) argued for the structuring of deals and the development of national accounting rules that would permit transactions to be scored as off-balance sheet, thereby evading the constraints on public debt imposed by the Stability and Growth Pact.

But it was unclear, until the ruling by Eurostat in February 2004, whether assets underpinning the services provided under PPP were classified as non-government assets and thus both the assets and their corresponding debt obligations recorded off the government's balance sheet. Under Eurostat's ruling, unless the private partner bears the construction risk and either the availability or demand risk, then the asset will count as a public sector asset. While this was widely viewed as a measure to rein in off-balance sheet projects, in practice these are easy requirements to fulfil. It would therefore seem that the Commission has moved from neutrality in relation to ownership to a preference for private ownership. The implications of this are discussed in chapter five.

## Response to the Green Paper

While there were about 200 responses to the Green Paper, largely from governments, both regional and national, there was no consensus that PPPs needed further regulation. Many thought that it would be better to wait to see how the new procurement Directives would work. There was generally little concern about the lack of homogeneity. In fact, the corporations saw this as a definite advantage, as the complexity favoured the sophisticated operator with experience and regulatory and market knowledge. Most responses did however seek clarification of the position relating to concessions and choice of private sector partners by 'institutionalised PPPs' where there is a joint public/private-owned public service entity. The EC's response to the consultation was to commission a study into the current practice for procuring PPP services within the EU and the impact of a new EU legislative initiative to regulate the procurement of concessions. But as of May 2008, this had not been published.

## Road PPPs in the EU

Our own search showed that in 2005, the annual capital value of signed deals in the EU, excluding the UK, had reached €9.3bn, before falling back to €7.7bn in 2006. Italy, Spain and France had signed the largest number of private finance deals. Transport, particularly roads and motorways, is by far the largest sector and rail, tunnels and bridges provide some of the largest projects.

It is however extraordinarily difficult to get information about signed PPP deals as there is no one database of signed PPP contracts in roads or indeed any other sector in the EU, and such information that is available is incomplete. Data collected for this study shows that by the end of 2005, the 25 countries that make up the EU had signed at least 145 PPP type arrangements for the construction and maintenance

of roads, bridges and tunnels, by far the largest sector by value financed by the EIB (EIB, 2005). As Table 3.2 shows, these projects are funded by different combinations of tolls, private finance and taxpayers' money via shadow tolls, which are usually volume-based payments by the public sector on behalf of users.

*Table 3.2 The number of PPP road projects in the European Union*

Country	Roads (toll)	Roads (shadow toll or availability)	Roads (unknown payment mechanism)	Bridges	Tunnels	Total
Spain	35	17	2		5	59
UK	1	22		3		26
Portugal	4	7			1	12
Greece	6		1	1	1	9
Italy	4		5			9
France	5			1	1	7
Ireland	3			3		6
Hungary	2	3				5
Netherlands		2	3			5
Poland	2	1				3
Germany					2	2
Finland		2				2
<b>Total</b>	<b>62</b>	<b>54</b>	<b>11</b>	<b>8</b>	<b>10</b>	<b>145</b>

Sources: various

Note: Signed deals as at 1st January 2006

The very first road projects were signed by Spain, which signed 15 projects, all for toll roads, between 1967 and 1975. There was then no activity until 1987 when both the UK and Ireland signed bridge projects, and Spain signed a tunnel project and another toll road. By the end of 1995, 28 projects had been signed including two road projects from

Hungary, the first of the accession countries to utilise PPPs in roads, though both projects subsequently failed. In 1996, the UK's Highways Agency signed the first eight DBFO shadow toll projects and Greece began signing projects as part of its PPP toll road program. In 1997, Finland signed the A4 road and Poland signed their first two projects. In 1998, Spain began a new programme of road building with PPP type arrangements, using shadow payments for the first time on two of them. In 1999, a further 14 projects were signed including the Herrentunnel in Germany and the first shadow toll programme in Portugal. By the end of 1999, there were at least 65 signed projects. After that, the number of signed deals grew quite fast and by the end of 2005, 145 projects had been signed.

The extent and pace of expansion reflects both national political priorities and national legal frameworks. By far the largest user of private finance in roads by capital value is Spain (Table 3.2), which has used private finance for roads ever since 1967. The UK comes second with about £3.3bn of PPPs. Other major users of private finance for roads include Portugal, Greece, France, Italy, Ireland and the Netherlands. Some have an active PPP road building/upgrading programme. While France and Italy used PPPs in the roads sector on an *ad hoc* basis, they are now beginning a more active PPP programme. Countries such as Germany, Hungary, Poland and Austria have used PPPs for individual projects rather than as part of a wider programme of PPPs. While Germany has now started a PPP roads programme at the state level, deals have yet to reach financial close. Twelve countries have no signed roads projects. While some of these have signed PPPs in other sectors, most had not signed any deals and were not expected to do so. But taken together, given the long gestation period before such projects become operational, there are relatively few projects that are up and running.

Government support has played a key role in the expansion of PPPs as the experience of both the UK and Spain, discussed in the next section, shows. Indeed, PWC (2004b) has remarked that the extent

of private sector involvement is chiefly associated with the political will of member states to promote them, as DLA Piper also noted (2004). This may take several forms. Firstly, the establishment of one or more PPP development units at central government level and/or in key departments, along the lines of the UK's Treasury Task Force and private finance units, in Austria, Ireland, the Netherlands, Denmark, Germany, Italy and Portugal. Secondly, the development of generic PPP legislation, as in Ireland, France, Germany, Portugal and Spain. Nevertheless, the complexity of such deals means that the procurement process is lengthy.

The payment mechanisms vary between countries. While several countries have had toll roads for some time, until very recently only Spain had privately owned and managed toll roads. In the 1990s, the UK used shadow tolls as its way of paying for its roads projects. As noted in chapter 2, in more recent projects, following criticism from the UK's NAO of shadow tolls which transfers risk to the private sector which it is unable to control (NAO, 1997; 1998), the UK has developed new payment mechanisms, such as availability payments linked to traffic speed and/or deductions for lane closures. Some payment systems aim to maximise safety. The UK and elsewhere, including Spain now use some mix of availability/shadow tolls for DBFO schemes.

The PPP ownership structures vary between countries. In France, concessions tend to be held by single and national construction firms with relatively little bank involvement, whereas elsewhere concessions/contract are held by consortia that involve banks and construction companies, typically larger foreign companies and some smaller national firms. In other countries, the consortia, made up of international companies, subcontract to smaller local firms. The consortia are made up of shifting alliances of companies so that while the same companies win many of the deals, it is not generally the case that the same consortia or SPVs win many bids. In so far as consortia have several projects, this is usually the result of takeovers.

Large scale projects require and attract a limited number of highly experienced bidders so there is limited effective *ex ante* competition even in the best organized tendering processes (Estache and Serebrisky, 2004). It would indeed be highly unlikely to get more than three or four bidders for large projects as industry concentration means that there are few players. Some markets such as France, Spain and Italy are seen as 'closed' because of strong domestic contractors and as such conflict with the EU's desire for international markets. The UK, Germany, Belgium, the Netherlands and Portugal are perceived as more open.

There is a high degree of concentration in the sector. Some 16 infrastructure companies were involved in 90% of the 147 projects, with just six infrastructure companies involved in 50% of the projects for which data relating to the partners were available, although more than one infrastructure company was involved in some projects. The Spanish companies (Dragados, Ferrovial, Abertis, OHL, FCC, Acciona and Sacyr) accounted for 52% of all new concessions and PPP projects over US\$50m under construction and signed between 1985 and 2003, although some of these companies have since merged. British Companies (John Laing, AMEC, Balfour Beatty and Alfred McAlpine) accounted for 14%. French companies (Vinci-Cofiroute, EGIS, Bouygues, Alstom) accounted for 14% and Australian companies (Macquarie, Transfield) accounted for 9%. The French and Spanish contractor groups have done well outside their own domestic markets, as well as ensuring that they retain their position at home. The most usual methods to enter overseas markets include lending to an existing operation, finding a domestic partner, and merging with or acquiring a domestic organisation.

Concentration in the construction industry has increased in recent years following takeovers and mergers and this has led to reduced competition in PPP procurement (Stambrook, 2005), as noted in chapter two in relation to the UK. This creates increased risk for the public sector because the companies are large and powerful enough to take on

the regulators in the case of conflict and force contract renegotiation on more favourable terms (Molnar, 2003).

While the information about the projects' financial backers and technical advisors is only available for about 90 of the 145 projects, it is clear that road PPPs frequently involve international financiers. The EIB has wholly or in part financed at least 50 such projects. The UK and Spanish banks have been involved in a number of the projects: Royal Bank of Scotland (16 projects), Banco Bilbao (15 projects) Banco Santander (9) and Lloyds TSB (9), in part reflecting the predominant weight of these two countries in such schemes. The German banks are however more heavily involved than the number of German projects would suggest.

While the predominant mode of operation in the UK is non-recourse financing via a project vehicle, whether bond or debt, it is still common in the EU to see a form of short term corporate debt of six or seven years for the construction phase. Within the European banks, there are a limited number of banks with project finance experience. While the structured or project finance teams are mainly based in London, the banks to whom those teams belong to are German, French, Dutch and British. In addition there are American and European investment banks with bond and debt teams and American monoline insurers that wrap the project risk for bond and debt holders. Thus, the banks with experience of project finance have been able to enter countries such as Italy and Spain, which traditionally have used corporate debt. In Germany, where the public authority effectively guarantees the repayment of the bank debt and hence underpins the Landesbanks that lend on such projects, two developments are likely to mean that Germany too will move away from corporate debt to project financing. Firstly, the European Court of Justice has criticised such arrangements under State Aid regulations and secondly, there are tighter provisioning requirements under Basle II for such arrangements with local banks. Thus, just as the corporations involved are international, so increasingly

are the financing arrangements. Furthermore, as the projects become ever larger, the advantages of project finance, that serves to isolate risks, will become more apparent.

The major advisors are dominated by the international Anglo-Saxon partnerships and include financial consultants PWC (23 projects), the engineering consultants Halcrow (13), Bank of America (10 projects), legal advisors Denton Hall (10 projects) and Faber Maunsell, Hambros and Steer Gleave Davis (each with seven projects). The UK advisors, or the British affiliates of international firms, have generally led the field as the UK model is generally perceived as a good starting point in risk allocation.

## **Private finance for roads in Spain**

Spain has been by far the largest user of private finance for infrastructure, with the private sector financing 20% of its infrastructure investment. Its private toll road programme began in 1967 with the offer of contracts of up to 50 years to the private sector to build, finance, and operate roads, and the right to charge vehicles to use the roads, alongside free roads, as isolated concessions rather than a network. The 1972 Concession Law, superceded in 2003 by a new law that covers all types of PPP, including the PFI model, was primarily intended for roads. The turn to private finance would, it was argued, provide the finance for infrastructure that the state itself could not afford. In general, those roads that were most likely to be profitable were franchised.

The private roads were not, however, built without cost to the Spanish government or financial problems for the companies involved. According to Bel and Fageda (2005), the financial, fiscal, and commercial conditions of the franchises were such that almost every risk was borne by the government. In particular, it provided state backed guarantees for foreign loans and exchange rate insurance against any increase in

the cost of finance raised by international loans, thereby reducing the concessionaires' exchange rate risk.

But several of the toll roads encountered financial problems because of high construction costs, the additional costs associated with tolling, and low revenues due to lower traffic volumes than anticipated, since many road users preferred to use the free roads. Spain's economic and exchange rate crisis of the 1970s and early 1980s following the rise in oil prices in 1978-79 further undermined the financial viability of the concessions. Three had to be taken into public ownership in 1984, a large number of the foreign loans had to be renegotiated, state loans were made available, the remaining contracts had to be renegotiated and in some cases, public subsidies were given (Farrell, 1997). By the end of 1994, the government had paid out €2.65bn and had further liabilities of €1.5bn in relation to foreign exchange guarantees that had not yet been called (Farrell, 1997). So expensive was the experience that in 1982, the incoming Socialist Party government reverted to a programme of road building based upon conventional public procurement, contingent upon economic expansion, increased tax revenues and, after 1985, extensive funding from the European Commission.

In the 1990s, after the constraints on public debt imposed by the EU, the incoming Conservative government once again turned to concessions for new roads. But by this time, the concessionaires, having formed in 1973 a trade association to promote their interests, had gained various legal, financial and accounting benefits from successive governments, which traditionally have had a close relationship with the construction industry. This was crucial in establishing a more secure financial regime for the private sector.

Firstly, the government passed a law to enable concessions of up to 75 years. Secondly, it renegotiated 13 year extensions to the existing agreements without entering into competitive bidding, legal under EU procurement law at the time and in some cases renegotiated the extensions in return for lowering toll prices, hence increasing traffic

flows and thus revenues, or undertaking further investments in other motorways where financial returns might be low. According to Bel and Fageda (2005), the renegotiations resulted in huge profits for the companies.

Thirdly, the government acknowledged that huge subsidies would be necessary for many of the new toll franchises to enable them to sustain the low levels of projected traffic volumes and the consequent financial losses (Bel and Fageda, 2005). According to Izquierdo (1997), half of the projected highways in the first phase of the new programme would require subsidies ranging from 40-65% of the total investment, which he expected to be in the form of 'non-refundable subsidies' or 'refundable advance payments', the then traditional forms of public support. In the event, the government changed its policy of supporting the concessionaires via direct subsidies and introduced what became known as 'participative loans', whereby the companies had access to cheap loans from the public authorities for some part of their financing requirements, and whose repayments were linked to their revenues from toll charges. Such arrangements, being scored as off the public sector's balance sheet for fiscal purposes, served to circumvent the constraints on public debt.

Fourthly, the concessions have benefited from a favourable pricing regime. The contracts awarded before 1988 were subject to little price regulation. In 1990, legislation established annual indexation of the tariffs slightly below inflation. That is, charges would increase by only 95% of the Consumer Price Increase (CPI) for the previous 12 months, subject to the permission of the corresponding public authority. During the late 1990s, there were individual agreements with each concessionaire to reduce tariffs and apply selective discounts, mainly to regular users.

In both 1997 and 2000, the government refused to allow charges to rise in line with rising and relatively high inflation. However, this did not lead to a corresponding reduction in post tax profits due to increasing motorway usage. The government's objectives in freezing the

toll charges were to control inflation, improve the distribution of traffic by encouraging the use of toll motorways, because many of them were underused while the alternative free roads were heavily congested, and to share the rising profits between the concessionaires and road users. In other words, by freezing the toll charges, it sought to increase traffic flows and thereby their revenues. However, the freeze was later ruled illegal and the government had to compensate the concessionaires.

Since 2000, a new system of revising tariffs, based upon price cap regulation, has been applied to the central government's toll concessions. This method is also based on the CPI but adjusted according to actual as opposed to forecast traffic. In essence, the largest toll increases are granted to the roads with the lowest traffic increases, and the lowest to those with the largest increases. The net result of this form of regulation, including the reduction in prices, has been to increase the volume of traffic using the toll roads (Bel and Fageda 2005), and thereby their profits. The system is not however universal, as the autonomous regions continue to revise tariffs based on annual increases of 95% of the CPI.

Fifthly, as Yescombe (2007) notes, the procurement process is fast and low cost, with Spanish projects incurring bidding costs about one tenth of those for a British PPP and procured within a much shorter time. This is apparently due to the greater amount of preparation by the public sector, including preliminary design, planning and environmental impact assessment, and prior consultation with the market before launching PPP tenders. In other words, greater costs are absorbed by the public sector directly and the private sector makes a much greater input into the nature of the projects it is willing to bid for.

Lastly and most importantly, the companies were able to secure a beneficial accounting regime that had real economic effects (Acerete *et al.*, 2009). The two most important benefits were the establishment of a reversionary fund, analogous to an additional depreciation fund, and the treatment of financing expenses such as interest payable.

Firstly, under Spanish accounting regulation, companies that operate an infrastructure concession, such as water or transport, whose assets will revert to the state at the end of the contract, could establish a reversionary fund. This became mandatory in 1999 for road concessionaires. Such a fund is created by making an allocation to a long term provision every year over the life of the concession, thereby increasing cost. Since the government accepts that the tariff must be set to cover not only the operating and financing costs but also the reversionary charge, this means that the road users must pay sufficient to cover this higher cost. In other words, the users will have fully paid for the asset over the life of the concession, which is shorter than the life of the asset. This allocation serves to increase the cash available to the company and is allowable for tax purposes.

Secondly, in relation to the treatment of financing expenses, in contrast to the international position, these can continue to be capitalised even after the asset becomes operational, subject to the existence of reasonable evidence that they can be recovered from future tariffs. While this is explained simply as a timing difference that should even out, in practice it serves to increase the returns to shareholders at the beginning of the contract, with no evidence to suggest that this will be reversed in the later years. Together, the reversionary fund and the treatment of capitalised interest have played an important part in consolidating the financial position of the concessionaire companies, enabling them to become a powerful force and global players in the road construction and operating business.

The use of private finance and tolls went alongside a further expansion of publicly procured and free motorways. By the end of 2004, 2,900km of private toll highways and 9,020km of free highways were in operation. Between 1995 and 2005, 19 private finance deals were signed, some being new developments for existing contracts. While eight were operational by 2002, some had still to open.

The Spanish PPP projects are dominated by the major construction companies and their subsidiaries. The financial investors play a much smaller role in financing the projects, as opposed to financing the companies. In effect, Spain operates as a market closed to foreign competition, although there is keen competition between domestic contractors. The road concessions have played an important role in boosting the construction companies' financial position and providing them with a launching pad to bid for similar deals overseas, particularly in Latin America.

In short, the Spanish experience confirmed some of the findings of the research literature cited in chapter one. The early contracts suffered from an overestimation of traffic volumes, the public's dislike of tolls, and the higher than anticipated costs, leading to the renegotiation and the public takeover of some concessions, and higher, but unquantified, costs for the government that appear to negate the stated objectives of the turn to private finance. The government's steps to make the recent concessions more financially viable for the private sector were key to ensuring the financial viability of the projects and ensuring healthy returns to both the financiers and owners in the last 10 years (Acerete *et al.*, 2009).

## Summary

The EU's enthusiasm for PPPs is linked to its wider deregulatory and pro-market agenda and the development of Trans-European Networks in transport. The fiscal criteria imposed by the Stability and Growth Pact have thus far provided the main rationale for PPPs in the context of a tight fiscal environment facing national governments. As such PPPs were promoted as a way of implementing the EU's transport policy. The EU does not, however, itself either commission or directly fund major transport schemes, although the EIB has been involved in financing a large number.

The lack of an explicit EU policy on PPPs and the diversity of practice in member states is viewed favourably by some large and powerful corporations, since the complexity favours the sophisticated operator with experience and regulatory and market knowledge. The use of private finance for public infrastructure is increasing and takes several forms, not all of which are identical to those in the UK, which makes regulation difficult.

The EU supports the use of private finance and partnerships, and plays a major role in framing policy via its rules on procurement and competition that impact on PPP procurement. However, the position relating to concessions and choice of private sector partners by 'institutionalised PPPs' where there is a joint public/private-owned public service entity is seen as requiring clarification and a more uniform practice.

While the EU's competition and procurement rules impact on the development and use of PPPs in member states, the expansion of PPPs is dependent upon the degree of political, institutional and regulatory support within each country. This, as the experience in Spain has shown, makes it imperative that there is full and timely disclosure of all the public subventions that may continue long into the future and/or may be called upon if things go wrong. The deregulation of transport and the growth of concessions and PPPs have been instrumental in creating large and powerful infrastructure companies, particularly in Spain, and financiers specialising in PPPs.

# 4 GOVERNANCE AND PPPs

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## Introduction

The purpose of this chapter is to examine the governance literature since the concept of governance determines the accountability requirements and hence the necessary reporting and disclosure. It draws a distinction between *corporate governance* of the private sector and *governance* of the public sector, before addressing the additional problems created by PPPs and the reporting and disclosure by the public and private sectors needed to ensure accountability for PPPs. It thereby provides a framework to analyse the actual reporting practices by all the parties involved in the seven case studies of chapters six and seven.

The chapter is arranged into seven sections. The first examines the development of corporate governance in the private sector from market-based to regulatory forms of control. It shows that a major focus of these developments is to ensure the quality of decision-useful information for economic decision makers. The second shows this has resulted in particular types of corporate governance mechanisms in the private sector, which have been mimicked and developed in the public sector. The third considers the fit between corporate governance, as transferred and developed, and the environment and role of the public sector. The fourth argues that PPPs represent a special governance case in which accountabilities to partners, the public and executive must be balanced. The fifth examines whether and how such accountabilities are balanced, and concludes that the executive is prioritised ahead of accountability to the public and its representatives. The sixth section considers the significance of these various accountabilities for a governance-based reporting framework. The final section presents a summary.

## Corporate governance: from markets to regulation

By the late 1970s, with the UK public sector portrayed as too large, inefficient and undisciplined, government policy sought to reduce the share of public expenditure in national income and to roll back the state. The private sector was to have a role in transforming public services by providing finance and management techniques. In essence, the public sector was to be reformed by becoming more like the private sector, enabling the two sectors to work more closely together (Bennett and Krebs, 1991).

As part of this process, in the early 1990s, private sector notions of corporate governance were transferred to the public sector, when the main recommendations of the Cadbury report were incorporated into a number of public sector governance codes (Hodges *et al.*, 1996). Later amendments imported ideas from subsequent corporate governance reports. The research literature however raises questions about the relevance of these recommendations in the public sector context.

The literature shows that although the rationalising rhetoric of corporate governance has focused on improving corporate performance, the key intended outcome of *corporate governance* is to maintain the confidence of capital markets and facilitate their operation. The main points that emerge from the literature are:

- Initially corporate governance was associated with the USA and the UK and with the mechanisms that direct and control large publicly listed companies at boardroom level. Little attention has been given to corporate governance in lower layers of the organisation;
- While the business environment of Europe is different from the USA and UK, similar corporate governance mechanisms are evident, albeit more attention may be paid to the needs of employee stakeholders;

- Corporate governance and its mechanisms focus on the division of power and responsibilities between the shareholders, the board of directors and the management, and on the quality of reporting in the financial statements; and
- Various corporate governance models exist in the private sector where companies choose a set of inter-dependent mechanisms, apparently associated with firm characteristics such as sector, size and ownership structure.

Traditionally, the market for corporate control was the cornerstone on which good corporate governance rested in market economies such as the US and the UK. This conception is grounded in Manne's (1965) argument that the stock market represents an objective evaluation of managerial performance, and that self-interest and decentralised markets function in a self-regulating and balanced manner (Cernat, 2004), as shareholders exercise their exit rights when performance is unsatisfactory.

Belief in the free operation of this mechanism faltered however in both the US and the UK in the wake of successive financial scandals in which shareholders unexpectedly lost their capital following the publication of financial statements that failed to signal clearly, if at all, that the company had financial problems (Edwards and Shaoul, 1999). Such losses were attributed to undesirable or even fraudulent behaviour on the part of management, unusual or creative accounting policies and practice, the limited role of auditors, weak links between directors' remuneration and company performance (Cadbury, 1992), and the relative ease with which dishonest and firmly entrenched chief executives were able to dominate the board of directors (Ezzamel and Watson, 2005).

It is not therefore surprising that much of the corporate governance debate is dominated by agency theory, which postulates a conflict

of interest between principals and their agents. Since owners are characterised as weak relative to managers (Roe, 1994), owners must reduce agency costs and control opportunism. While it may be possible to manage this conflict with contracts offering managers incentives to act in the preferred way (Jensen and Meckling, 1976), Hart (1995) argues that corporate governance structures are necessary because agency problems cannot be resolved entirely by contract: managers usually retain significant control rights over the allocation of investors' funds (Shleifer and Vishny, 1997).

Thus, although corporate governance may be an issue in small closely held firms, it is normally considered to be a much more significant issue in large public companies (Hart, 1995), whose shareholders may free ride rather than participate in decision-making or monitor management (Berle and Means, 1932). Similarly, relatively little attention has been given to how corporate governance works in subsidiaries, associates or joint ventures.

Other than details surrounding one or two tier board structures, corporate governance codes in EU countries show little substantive difference, although the role of the banking sector affects the rationale for disclosure and how monitoring mechanisms operate (Millar *et al.*, 2005). In Europe, unlike the UK where there is no formal mechanism for employee participation, there is some promotion of non-shareholder constituencies (Coffee, 1999). Nevertheless, the practices of corporate governance are similar throughout the EU (European Commission, 2002), despite different and diverse cultures, financing traditions, ownership structures and legal origins that lead to differences in reporting policy and practice.

If corporate governance's concern is with the external perceptions of its value, then the purpose of visible mechanisms is to signal that decision-making is controlled. Organisations may be able to de-couple administrative rules and rituals from practical activities (Pressman and Wildavsky, 1974). That is, the mechanisms may not in practice perform

the tasks of monitoring or controlling for which they were formally established, even though their existence may serve to maintain capital market confidence.

Empirical evidence suggests that the choice of corporate governance mechanisms is not random but is related to the company's characteristics such as: sector, size, concentration of ownership, the strength of shareholder influence, nature of performance measures, and whether it has a single or two tier board structure. That is, different models exist in the private sector, and the individual elements of each firm's corporate governance structure are inter-dependent (Agrawal and Knoeber, 1996; Weir *et al.*, 2002), and interact to determine a firm's governance environment (Jensen, 1993; Shleifer and Vishny, 1997; and John and Senbet, 1998).

Despite some differences internationally, corporate governance is viewed at a micro level in terms of how corporations are directed and controlled in pursuit of shareholder wealth. Good governance provides control while promoting economic enterprise and corporate performance (Keasey *et al.*, 2005a), so that shareholder value is enhanced and shareholders' funds are not expropriated or wasted on unattractive projects (Shleifer and Vishny, 1997). That is, the focus of attention is on the economic decision maker and this affects the kinds of mechanism needed to achieve this kind of corporate governance.

## **The transfer of corporate governance to the UK public sector**

Since the early 1990s, there has been a spate of reports, including the Cadbury Report (1992), Greenbury (1995), Hampel (1998), Turnbull (1999), Higgs (2003) and Smith (2003), so numerous that Keasey *et al.* (2005b) argue that they risk harming the balance between accountability and business prosperity. These reports require or recommend monitoring procedures and structures that seek to achieve two major outcomes: (i)

to control and thus change the operation of the Board; and (ii) improve the quality of reporting. Three authoritative sources show that, as in the private sector, governance in the public sector has become associated with these two outcomes.

These sources include: (i) a governance model issued by the Audit Commission for its own governance, but also described as a model of excellence, to act as best practice guidance for the public sector; (ii) recommendations from CIPFA, the public sector accounting professional body, contained in *Corporate Governance: A Framework for Public Service Bodies* (CIPFA, 1995), and guidance from *The Independent Commission For Good Governance In Public Services* (CIPFA, 2005b); and (iii) the most recent guidance from the Treasury, the *Code of Good Practice* (Treasury, 2005b), intended specifically for central government departments and adopted by the Department for Transport (DfT), therefore of interest to this study.

Similarly, other sources of specific relevance to this study also focus on these same outcomes. These sources are the corporate governance guidance produced by the Welsh Assembly Government (undated), the Scottish Government (until recently the Scottish Executive) (2003), and Transport for London (TfL) (undated). This similarity is not surprising since the first two sources refer to the influence of the Treasury in establishing their governance guidance and TfL refers to the CIPFA/SOLACE framework (SOLACE, 2005), which is substantially the same as CIPFA's earlier codes.

In the context of the first objective - controlling the operation of the Board - the private sector's reports in essence assume that the Board acts as the shareholders' representative, charged with monitoring management. Typically, these reports have:

- highlighted the need for, and controlled the content of, corporate charters;

- attempted to tighten control of internal mechanisms around decision-making processes in the board room; and
- focused on ways to encourage institutional shareholder activism and more independent boards by using remuneration policy to align executive and shareholder interests (Watson and Ezzamel, 2005).

Some public sector sources, such as the Treasury, adopt the private sector definition of corporate governance as the way in which organisations are directed and controlled, although others expand this definition. For example, TfL identifies five fundamental principles of governance: openness; inclusivity; integrity; accountability; and effectiveness.

The guidance stresses the role of the Management Board in corporate governance. For example, the Treasury Code focuses on how, within the strategic framework set by the minister, the Department Management Boards can support the head of department by advising the minister and taking ownership of the department's performance (Treasury, 2005b). The Welsh Assembly Government Management Board has a corporate governance sub-committee.

Similarly, the Audit Commission's model includes a Governing Board to monitor performance and ensure that the Audit Commission acts within its statutory remit (Audit Commission, 2006). The roles of Chief Executive Officer and Chairman of the Board are split as advised in private sector practice. The Audit Commission sets out financial criteria for matters that must be approved by the Board (Audit Commission, 2006), which matches Treasury guidance that there should be a schedule of matters reserved for board decision.

In relation to the second objective, improving the quality of reporting, the Anglo-American market-based corporate governance model equates institutional transparency with the disclosure and dissemination of financial information, enabling monitoring by diversified shareholders.

Especially in the UK, governance by disclosure (Ezzamel and Watson, 1997) has been pursued. Typically, regulators have sought to increase the quality of internal control systems, disclosures, and the independence of external auditors.

To achieve these aims, private sector regulators have concentrated on the membership of the Board, emphasising the role of outside independent directors, whose rising numbers have been one of the most visible elements of private sector corporate governance reform internationally (Dahya *et al.*, 2002). They have also recommended the creation and then strengthened the role of board sub-committees, such as, audit, nomination and remuneration committees.

However, the exact nature of the purpose and responsibilities of board sub-committees is unclear, with the Cadbury Report (1992) for example failing to spell out precisely what such board committees were supposed to achieve or how they were to hold directors to account (Ezzamel and Watson, 1997). Others have argued that the adoption of audit committees may be symbolic (Kalbers and Fogarty, 1993) and their role ceremonial (Spira, 1999). Nevertheless, despite these criticisms and a lack of evidence that audit committees can further the interest of the public (Guthrie and Turnbull, 1995), board sub-committees, especially audit committees, have been mimicked in the public sector.

The Treasury (2005b) guidance indicates that the board should be independently advised by an internal audit service and an audit committee, chaired by an independent non-executive member. The Audit Commission's model includes an audit committee whose terms of reference focus on overseeing the production of the annual accounts, reviewing the choice of accounting policies and practices, and overseeing the internal control systems and the work of internal and external auditors (Audit Commission, 2006). TfL's audit committee, one of four board committees, is tasked with oversight of corporate governance.

Private sector regulators have also focused on improving the quality of internal control systems, especially systems associated with the assessment, management and disclosure of risk, about which top management have been required to make statements in the annual report and accounts. Regulators have emphasised the primary responsibility of directors, as opposed to external auditors, for internal control. This has led to the strengthening of internal audit departments, improved reporting access for chief internal auditors to Board rooms and demands for greater liaison between internal and external auditors. However, the form of such reporting under Turnbull's recommendations (1999) results in little meaningful information on risk being disclosed (Hood *et al.*, 2006). These arrangements have also been mimicked by the public sector with similarly banal outcomes.

Treasury (2005b) guidance requires the Board to ensure that effective arrangements are in place to provide assurance on risk management, governance and internal control. CIPFA (2005a) recommends the auditing of risk management, control and governance processes. Furthermore, the Treasury has established a *Risk Management Framework* (2001) which includes working with departments on the improvement of risk management and internal control. This entails a regular process of risk assessment managed by each department's internal audit team and approved by its audit committee. This requirement results from the Treasury's view that the main responsibility for managing most risks relating to expenditure falls on individual departments.

While corporate governance mechanisms were designed in the private sector to control the activities of the main board of directors, the Treasury Code also contains guidance about the relationship between departments (Treasury 2005b), which are concerned with policy, and Arm's Length Bodies (ALBs) such as executive agencies, which implement the department's business. In essence this relationship is to be managed by a written Framework Agreement 'drawn up to suit the ALB's legal standing and the environment in which it operates' and by

cross membership of governing boards (Treasury 2005b). The Highways Agency, for example, has its own governing board, with cross membership on the DfT's Board and audit committee.

The concept of governance by disclosure has also been mimicked. For example, the TfL guidance identifies disclosure about performance of service delivery as an important means of achieving its 'public focus' dimension of governance. CIPFA (2005a, p.15) argues that good governance may be demonstrated by making the following disclosures about the activities of the Board and the audit committee:

- A review of corporate governance. This is consistent with the Smith Report's (2003) recommendation that governing bodies should review their own performance;
- An audited statement about internal control processes, especially offering assurance that all key risks have been identified and managed; and
- A statement about corporate governance presented with the financial statements.

Thus, as in the private sector, these public sector mechanisms focus on corporate governance type monitoring and controlling activities, especially in relation to financial probity.

However, best practice guidance from CIPFA and the Audit Commission has been developed to include three principles that are generally less evident, or absent, in the private sector. In some, but not all, cases the Treasury Code also reflects these notions. The first principle is that corporate governance leadership is expected to be given (CIPFA, 2005a) and decisions made in the public interest (Treasury, 2005b). To this end governing bodies are expected to operate in an ethical manner with probity and integrity in line with the seven Nolan principles<sup>1</sup> (Nolan, 1995) for the conduct of people in public life (CIPFA, 2005b;

Treasury, 2005b). They should provide the public the means to challenge sub-standard governance, including instances when an organisation fails to demonstrate the spirit and ethos of good governance (CIPFA, 2005b). For example, according to the Audit Commission's model, the Governing Board should approve, publish and maintain a complaints procedure that includes holding the Chairman responsible for responding to such complaints. Although the Treasury's guidance is silent on outsider complaints, it recommends that there should be a process whereby staff can raise concerns with independent non-executives.

Second, good governance is linked to good quality outcomes for service users, especially the most needy. The role of governance is:

*To ensure that an organisation or partnership fulfils its overall purpose, achieves its intended outcomes for citizens and service users, and operates in an effective, efficient and ethical manner.*  
(CIPFA, 2005b, p.7)

The Audit Commission seeks to achieve 'better outcomes for citizens, with a focus on those people who need public services most' (Audit Commission, 2006, p.3). However, although the Treasury Code makes reference to performance management, there is no explicit reference to performance as it relates to the needs of service users.

Third, governance is linked to the quality of organisational relationships and levels of morale. *The Independent Commission For Good Governance In Public Services* recognises that governance is a dynamic process, which if good may lead to good management, good performance, good stewardship of public money, good public engagement and good outcomes (CIPFA, 2005b), but if bad may foster low morale and adversarial relationships, poor performance and dysfunctional organisations (CIPFA, 2005b). Corporate governance is intended to:

*...encourage high standards of propriety and promote the efficient and effective use of staff and other resources throughout the Commission. (Audit Commission, 2006, p.8)*

But this cannot be achieved simply by following rules and procedures, as it flows from a shared ethos or culture (CIPFA, 2005b). CIPFA therefore suggests that governors have a responsibility to the organisation's staff, which should be discharged actively and in a planned manner. The Treasury Code, allowing staff to raise concerns with independent non-executives, reflects a reactive rather than proactive stance.

Alongside this general purpose of corporate governance, CIPFA (2005b) establishes six core principles of good governance common to all public service organisations, which are listed in Table 4.1. CIPFA (2005a) suggests that in its earliest forms corporate governance was mainly about minimising risk and avoiding failure, but that this assurance role grew to include improving performance by focusing strategic thought on clear and robust systems and control processes. Good governance is now perceived as providing a structural basis for achieving fundamental policy goals (CIPFA, 2005a).

That is, within the guidelines there is evidence of movement up Stewart's ladder of accountability (1984). Where previously the focus of governance mechanisms was on issues of probity and legality, the lowest rungs of the ladder, the need to consider accountability for programmes and policies and their outcomes requires a progression to the highest rungs. At this level Stewart has argued that accountability should be judgemental in nature, since it is difficult to provide clear measures of accountability, but Broadbent *et al.* (1999) argue that this is not necessarily the case. They argue that the managerialist approach of setting targets and measuring performance, using technologies of accounting, operates as a control device that is counter to the call by Stewart for the exercise of judgement.

*Table 4.1 Core principles of good governance*

CIPFA's core principles of corporate governance
Focusing on the organisation's purpose and on outcomes for citizens and service users
Performing effectively in clearly defined functions and roles
Promoting values for the whole organisation and demonstrating good governance through behaviour
Taking informed transparent decisions and managing risk
Developing the capacity and capability of the governing body to be effective
Engaging stakeholders and making accountability real

Source: CIPFA (2005b)

## **The relevance of corporate governance to the UK public sector**

There are now numerous alternative structures for the delivery of public services (Hodges, 2005), reflecting changes in the intentions about and the practice of accountability. This section reviews literature to consider how these private sector notions of corporate governance, as amended in the public sector, fit that environment. As Turley and Zaman (2004) have argued, the underlying organisational culture, the relational dynamics and the interaction of any one corporate governance mechanism with other internal structures will influence the effects of corporate governance.

Accountability has been described as a chameleon-like term that has been attached to a wide range of causes and agendas (Dubnick and Justice, 2006). In its simplest form, it entails a relationship whereby some people are required by others to explain and take responsibility for their actions: 'giving and demanding reasons for conduct' (Roberts and Scapens, 1985, p.447). Accountability thus focuses on 'who' is to be accountable to 'whom' and 'for what'. In the public sector

context, it has three aspects: (i) compliance, being held to account; (ii) transparency, giving an account; and (iii) responsiveness, taking account (AccountAbility, 2004).

In 1970, Warham described public sector accountability as located in the field of professional competence and in the exercise of professional discretion, bounded by rules that govern the performance of statutory duties. Governance of the public sector was based on hierarchical, bureaucratic mechanisms underpinned and infused by a public service ethic, and professionals were usually accountable to their peers. Thus accountability was an intra-organisational issue (Warham, 1970).

However, the reform process of the 1980s created a shift to governance by market principles, legitimised by theories of institutional economics, markets and hierarchies. The proponents of these reforms believed that VFM would be best secured by the private sector or, if this was not possible, through quasi-markets within and between units of the public sector. Reform was based on the belief that market-based transactions provided a more rational and efficient way of organising than hierarchical or clan forms of governance (Ezzamel and Willmott, 1993).

There were two inter-related aspects to these reforms. First, there was the political rise of finance professionals and the use of the language of accounting in a sector where historically there had been an absence of accounting information and methods of management control. For example, there was a notable advance in cost awareness and a switch from management of policy to management of resource, with an emphasis on individual responsibility and accountability for resources rather than collective stewardship (Gray and Jenkins, 1993). The notion of accountability implicit in the changes of the 1980s was based on agency theory, forms of financial control (Cochrane, 1993), and a strong belief in the objectivity of financial measures.

In particular, it was the Financial Management Initiative (FMI) and the executive agencies that changed the character of public

sector delivery (Gray and Jenkins, 1993) and promoted the power of accounting. Launched in 1982, the FMI promoted accountable management by ensuring that each department had clearly defined objectives, clear responsibilities for managers, and relevant information to enable the execution of responsibilities (Cmnd. 8616, 1982). Departments were required to draw up documents outlining 'the way they manage all aspects of their programmes and to work out the best pattern of managerial responsibility, financial accounting and control' (Cmnd 8616, 1982, para.14). It would enable decision-making about programme development to be better informed and performance to be assessed on a range of indicators of both operational achievements and their costs.

However, a review of FMI in 1987 indicated there were structural obstacles to the achievement of decentralised responsibility and accountable management (Jenkins *et al.*, 1988). Consequently, the Government's Efficiency Unit recommended the creation of executive agencies within each department. These agencies (including the Highways Agency in England) would have some organisational independence to implement policy determined by Ministers. The review emphasised the development of internal markets and tendering to the private sector with agencies modelled on divisionalised companies (Ezzamel and Willmott, 1993), classically controlled via financial measures.

Departments would become confederations of agencies providing goods and services in a quasi-commercial environment, with a small head office staff serving the Minister's policy requirements. Greater external accountability was to be achieved by the publication of a framework document setting out explicitly each agency's aims and objectives and describing the monitoring, accountability and reporting between the agency and its parent department (NHS, 1989). This was a change to previous practice in that objectives for units of the civil service were traditionally for internal management purposes only.

The second aspect of these reforms was the demand for more inspection and more effective external scrutiny via oversight from central government and accountability to parliament. Revamped in 1979, the Departmental Select Committees were charged with examining three aspects of each department and its associated public bodies: spending, policies and administration. Over the years the names and numbers of these committees have changed to reflect organisational changes in Whitehall, but at present there are 19 committees, including, of relevance to this research, the Transport Committee and the Scottish and Welsh Affairs Committees. It is argued that these committees enhance scrutiny (House of Commons, 2002). These committees are the primary users of departmental accounts (Likierman and Taylor, 1990), with their members becoming specialists in the area (House of Commons, 2002). The information they gather and subsequently publish is valuable in terms of holding Ministers to account (Procedure Committee, 1990).

Oversight is additionally carried out by a number of committees that have cross-departmental remits. The most important is the PAC, whose remit is to examine accounts that show the expenditure of appropriations granted by Parliament and any other accounts laid before Parliament it thinks fit. The National Audit Act of 1983 gave the Comptroller and Auditor General the power to report on the economy, efficiency and effectiveness of government bodies' use of public funds and on VFM achieved by departments. Its reports are considered by the PAC, which has the power to request the NAO to carry out investigations. Similarly, both Scotland and Wales have their own Auditor General's office.

Political accountability defines the relationship between citizens and their representatives and is ultimately determined through the ballot box. But bureaucratic accountability requires government to be held to account either directly by citizens and/ or by elected representatives and representative institutions. That is, there are two accountability streams: an upward accountability that is ultimately to Parliament, as discussed above; and a downward accountability to the public in its various forms

as taxpayers, voters and service users. Downward accountability is important because:

- Many services are monopolies to which access is intended to be, even if it is not, equitable;
- Since the risk-taking taxpayers who provide finance cannot exit, a market for corporate control cannot operate. Arguably, there is an emerging market for public sector control since some public authorities deemed to be failing may be subject to takeover. For example and most publicly, new head teachers and management teams have been appointed to turn around failing schools under special measures, resulting in a loss of control by existing managers; and
- The range of available actions to hold public authorities to account is limited (Stewart, 1984). Citizens may only act indirectly via the ballot box, or directly via open meetings, although the way open meetings operate in practice may not be conducive to stakeholder action (Hodges *et al.*, 2004; Clatworthy *et al.*, 2000).

Government has been described as a serial set of principal-agent relationships with citizens as the ultimate principal (Moe, 1984). It is, however, difficult to determine how and where the principal/ agent relationship that drives private sector corporate governance is replicated in the public sector. Furthermore, accountability is associated with a wide range of activities including: compliance; the use of funds for the purposes intended by Parliament; VFM; transparency; and responsiveness.

Thus, Smith *et al.* (2006) argue that public sector governance has a number of elements: internal governance in terms of structural elements, such as a written constitution; member conduct; external accountability, and public access as reflected in the transparency and openness of

operations. However, Broadbent and Laughlin (1997) argue that real accountability requires government not only to justify its actions but also to critically evaluate them.

### **PPPs: A special governance case**

PPPs present further problems for bureaucratic accountability because the public sector remains responsible for services it does not deliver. As such, they constitute a further example of a process described by Rhodes (1994) as ‘the hollowing out of the state’ following on from the outsourcing of ‘non core’ services and the liberalisation and commercialisation of services. This hollowing out of the state mirrors that of corporations which have outsourced their operations, with some such as Nike retaining little more than design and marketing. Arrangements such as PPPs generate a number of political and service performance risks that need to be directed and controlled. But the crucial point from the perspective of this study is that corporate governance codes emphasise shareholder needs and largely ignore the governance issues generated by these new hollowed out organisational forms in relation to other aspects of performance.

PPPs present new governance issues due to:

- the involvement of private financiers in the structuring of projects, and the impact of their risk-return criteria on project formulation;
- the nature of the relationships and the organisational structures of the parties to the contract;
- problems of performance measurement, especially related to the self-monitoring nature of contracts; and
- The relative power of the contracting parties and the complexity of the contracts, as evidenced by the difficulties the public sector has

encountered in imposing effective sanctions for poor performance, something that Standard and Poor's (2003) noted that worked in the private sector's favour.

### **The role of private finance**

While the private sector has always built infrastructure for the public sector and is increasingly involved in the provision of services due to outsourcing, privatisation and liberalisation, the new element that PPPs introduce is private finance, subjecting key investment and procurement decisions to the risk-return criteria of financiers. As a result, the financiers may require guarantees and alter the characteristics, content, and payment mechanisms of projects that fail to meet their standardised expectations. As explained in chapters two and three, this has led to frequent amendments to projects in the UK at preferred bidder stage, by which time there is a lack of competitive pressure. In other words, a project may look very different at financial close to that originally advertised. Furthermore, as the business cases and contractual documents typically remain secret, it is impossible to examine the impact of such requirements on the project.

This raises governance issues about risk-return management of the project prior to financial close and about whether and how risk that is priced in the contract is actually transferred at later stages, especially when risk is to be shared across organisations. Moreover, risk management processes that focus only on the project or at unit level, as is common in the private sector, deny the particular characteristics of government as responsible for planning, organising and monitoring public service provision and as risk bearer of last resort (Froud, 2003).

## Relationships and organisational structures

The nature of PPP relationships and the organisational forms associated with them are different and more complex than the contracting out of services that were simple, legally-protected, market-based, arms-length purchases of a relatively short duration (Broadbent and Laughlin, 2003). PPPs are long term contracts, with extended supply chains and multiple and changing partners. Consequently, this blurs the distinctions between political accountability and more technical forms of accountability that arise from contractual and quasi-commercial relationships (Alexander, 1991).

In addition, large sums of public money are spent by non-elected agencies, which work through complex networks where the lead agency and the channels of accountability may be unclear (Cochrane, 1993). Many PPPs, as in transport, are signed by such agencies whose financial objectives may diverge from the interests of their users, particularly if there is limited competition and asymmetric information between consumers and producers. Although the FMI initially aimed to provide better quality information for decision-making, there is no guarantee that such information will be public: it may be withheld to protect the agency's profitability (Rutherford, 1992). While the creation of agencies need not have a major impact on financial control and accountability (Pendlebury *et al.*, 1994) inevitably there is pressure to recognise their independence (Rutherford, 1992).

Furthermore, in PPPs the private sector partners also have complex organisational structures in which the SPV usually sub-contracts project construction and operations through a web of related companies. Although PPP is intended to produce savings because of the integration of design, construction and operations over the life of a long term contract, in practice the membership of the web of companies changes over time and members' interests may conflict and vary between the different stages of the contract.

## Performance measurement

Since the public sector specifies outputs not inputs under PPP, it loses control over inputs. Contract control therefore focuses on the measurement and monitoring of performance outcomes. However, this is notoriously difficult, because the intangibility of some services means that outcomes are difficult to specify, and measuring outcomes against the stated objectives is likely to be very difficult (Haight, 2002). Moreover, public sector management information systems were not designed for this purpose (Kirkpatrick and Lucio, 1996; Arrunada, 2000). Although systems for measuring outputs were introduced, initially for managerial and latterly for public accountability purposes (Cutler and Waine, 1997), they did not prove easy to implement. Various reports from the NAO and PAC show how these systems failures adversely impacted performance monitoring and accountability in practice (see for example NAO, 1999b; NAO, 2002c; NAO, 2003b; PAC, 2002a; PAC, 2002b).

The involvement of a web of companies creates a long supply chain in which costs and performance measures are diffused through different companies, which are individually responsible for the monitoring systems. That is, the private sector contractors collect performance data to assess their own performance against measures they design and control. With the transfer of the work force to the private sector, the public sector may lack both the necessary expertise and the personnel to evaluate performance measures. In such circumstances, performance standards may be disputed, with no organisation accepting responsibility for poor performance (Edwards *et al.*, 2004). In this complex environment, governance arrangements must cover 'internal control' systems for measuring service performance across multiple organisational boundaries.

## The relative power of partners

Partnerships are not by definition, fair, equal or good (Nelson, 2002). The often unequal power relations between the partners become evident in the context of poor performance when procurers lack effective sanctions (Edwards *et al.*, 2004) and/or the resources to impose them. Furthermore, the political sensitivity and the essential nature of the services, as well as broader political choices by the government, often make it impossible in practice to terminate the contract (Edwards and Shaoul, 2003). That is, neither market forces nor contractual terms are capable of ensuring efficient and effective performance.

In short, the governance problem in PPPs is to direct and control, over the long term, complex relationships between multiple and changing partners bound by contracts that may be difficult to enforce or terminate and soon become dated, and where clear lines of responsibility are lacking. Crucially, this governance problem has to recognise that the public sector bears the ultimate risk, political risk, which must be managed. However, despite the now widespread use of the private sector to deliver public services via a variety of market mechanisms, none of the Codes make more than a passing reference to this issue. This is illustrated by the Treasury's footnote in its governance guidance that 'there may also be value in considering the department's relationship with, for example, PPP and PFI providers' (Treasury, 2005b, p15). In essence, the Codes do not address the accountability problems posed by the governance of market mechanisms.

## Accountability streams

PPPs imply a third accountability stream in addition to the upward stream to Parliament and the downward stream to the public, a horizontal stream (Smith *et al.*, 2006) where the direction is from the private sector service providers to the procuring public authority.

Furthermore, both upward and downward accountabilities have little substantive meaning without such horizontal accountability. While CIPFA explicitly recognises this tripartite relationship (2005b), its view is that it is necessary to 'balance' the accountabilities between partners, to the public interest and to government, which does not apparently give pre-eminence to any one stream. However, most of the discussion has focused on the upward and downward streams.

The Treasury's and the Audit Commission's Codes of Governance articulate the governance relationship between the public authorities and Parliament, the upward stream. This is focused around the role of designated Accounting Officers (AOs), who are personally responsible to Parliament for the resources under their control, for signing the annual accounts and acting as witnesses before the Public Accounts Committee. The Audit Commission sets out the responsibilities of the AOs in detail. Smith *et al.*'s (2006) notion of upward accountability is indeed well specified, even if the associated oversight has limitations. These limitations include the following:

- Agencification has reduced both the detailed scrutiny by individual elected representatives and the Parliamentary accountability of ministers for services (Mayston, 1993), and some committees have neglected the agencies within their remit;
- Civil servants rather than Ministers may be called to account before Parliament (Gray and Jenkins, 1993) so that ministerial accountability and scrutiny is patchy and spasmodic;
- Select committees are hindered by the non-attendance of witnesses, rapid turnover of members, premature disclosure of reports, the nature of the Prime Minister's accountability to select committees, and the proliferation of executive agencies (House of Commons, 2002);

- The National Audit Act 1983 does not permit the NAO to question policy; and
- The failure to follow through the recommendations of scrutineers. For example, the Modernisation of the House Select Committee (1999) noted a failure to debate select committee reports in the House, and a lack of consistent analysis of whether recommendations are taken up by the relevant department.

In relation to the downward stream, free market reforms have emphasised the interests of consumers and taxpayers, and greater accountability to service users (Bowerman, 1998). Competition would reduce the power differentials between providers and users (Mayston, 1993). Citizens were to participate in decision-making processes (Fowles, 1993). However, in practice there have been tensions between upward accountability and this new rhetorical focus. For example, while Pendlebury *et al.* (1994) find greater accountability to customers for public sector goods, they note that this has promoted an entrepreneurial public sector that is at odds with the public administration tradition of stewardship and probity. The emphasis on financial control and scrutiny by the Select Committees, the PAC and the NAO is likely to strengthen accountability upwards towards central government (Fowles, 1993), with a consequent shift away from accountability to the public at large (Parker and Gould, 1999).

Despite the new focus on accountability to the public that emphasised value for money for taxpayers, quality of services for users, and customer choice, the careful specification of upward accountability is not replicated in relation to downward accountability to the community. Although, for example, the Audit Commission stresses the importance of scrutiny by the public, it does not discuss how this is to be operationalised. TfL's guidance indicates that proper arrangements

will be designed to encourage participation, but does not specify the content of these arrangements.

In short, the guidance promotes upward accountability at the expense of both downward and horizontal accountability. However, this upward accountability is limited by the absence of guidance for horizontal accountability. This matters since collaborative partnership arrangements are especially difficult to govern (Smith *et al.*, 2006), and monitoring is hindered by a lack of quantitative data (Smith, 1992). From the perspective of this study, which focuses on accountability to the public, the lack of specific guidance on both downward and horizontal accountability makes it unlikely that useful information is made available to the public.

## **Governance-based reporting and disclosure framework**

The concept of these three streams of accountability is now used to develop a reporting framework to enable the public to examine the decision-making process and management of PPP projects and to challenge sub-standard governance (CIPFA, 2005b). To do so there must be transparency about how governance is intended to operate, as well as information enabling an assessment of whether or not it operates in any given area of the public sector.

According to Smith *et al.* (2006), there are four elements of governance: structures of internal governance; member conduct; external accountability; and public access.

The first element, the internal structures, establishes the organisation's objectives and its reporting lines and board membership processes for control purposes. In the context of PPPs, such structures must enable governance across organisational boundaries, both within and between the public and private sectors for horizontal accountability. Whereas in the private sector, structures of governance are focused on the top tier of the organisation, in the public sector significant decision-making

responsibility rests below departmental level. Thus internal structures of governance and notions of transparency must filter down through the organisational hierarchy, especially into agencies.

The second element relates to member conduct. While members of governing bodies are expected to conform to the Nolan principles, it is difficult to prescribe how a principle such as selflessness might be measured. In accountability terms, Smith *et al.* (2006) highlight potential conflicts of interest, which are usually controlled by publicising their existence. However, it is unclear how far this approach to member conduct suffices where, as chapter two has highlighted, PPP is the only game in town.

Important as these two elements are, they are generic across the public sector. Since the focus of this study is on the last two of the four elements of governance, this framework concentrates on external accountability and public access. In the context of PPPs, governance should enable an external account to be given in relation to: use and stewardship of resources; quality of services; financial probity; and financial control over public monies both in the present and in relation to future commitments. So, there may be interest in individual transactions or outcomes rather than in a single measure of performance as is common in the private sector. Thus accountability requires greater disclosure than is usual in private sector financial statements. In particular, accountability requires the disclosure of non-financial information to enable an assessment of service quality, and disaggregated information to enable the assessment of large-scale projects, for example PPPs, undertaken by public authorities. Table 4.2 suggests the kinds of information that are needed. Much of the necessary financial and non-financial information is dependent upon the provision of or access to information generated by their private sector partners, who are *de facto* public authorities. It also entails an assessment to be made of any future risks and liabilities that may flow from PPP contracts, including

the financial viability of their private sector partners and the ring fencing of their surpluses for future maintenance expenditure.

*Table 4.2 External accountability*

<b>Information needed for external accountability</b>
Traditional financial statements from public and private sector partners
Budgeted and actual annual expenditure by the public authority
Information to enable assessment of performance from all relevant parties in terms of quality of and access to services by partners, Parliamentary bodies charged with oversight, elected representatives and informed citizens
Information from the public authority to enable assessment of financial controls, risk management and controls over resources by partners, public watchdogs, elected representatives and informed citizens
Information about risk pricing and risk transfers associated with PPPs and evidence of transfer actually occurring
Details of self monitoring of PPPs and withheld incentive payments
Mechanisms for ensuring internal review, external scrutiny and the follow up of recommendations by watchdogs are implemented by the public authority
Termination arrangements

Understanding and challenging governance clearly requires public access and transparency, but at present the downward stream of accountability is not well specified, leaving it unclear how public access is intended to occur. Table 4.3 makes some suggestions for operationalising public access. These include how to: request information under the *Freedom of Information Act 2000*; challenge governance; complain about specific aspects of service; and make suggestions for improvement to services. This necessarily means that systems should be responsive, timely and easily accessible.

Table 4.3 Public access

Suggestions for increasing public access
Descriptions of arrangements to ensure transparency by all relevant parties
Explanation about the decision-making processes and points of public intervention in these processes
Explanation about any non-disclosure linked to commercial sensitivity and a time frame for the lifting of any such secrecy
Specification of suggestions and complaints procedures, and procedures for response by the public authority
Descriptions of how citizens can use the <i>Freedom of Information Act 2000</i> in the context of each reporting unit
Information about how governance can be challenged

Although this multi-faceted governance-based reporting framework offers huge scope for research investigation, this study is focused on the reporting and transparency required for PPP projects. Thus the empirical work will concentrate on external accountability and public access elements of governance as they relate directly to this objective. This study excludes internal structures, member conduct and challenges to governance, which are of a generic nature rather than specific to PPPs.

Table 4.4 sets out some detailed research questions about the reporting and disclosure to be examined in the case studies. These focus on: the six lifecycle stages and key characteristics of PPPs identified in chapter two; the accessibility and timeliness of information; and the usefulness of the information for understanding the cost and sustainability of PPP projects.

*Table 4.4 Research questions relating to reporting and disclosing the costs of projects*

Research questions to be examined in the case studies
What information is available, in both public and private sectors, about decision-making before financial close?
What is the role of the private sector in generating PPP projects?
Does the annual reporting in both public and private sectors during the operation phase provide useful information?
Is information provided about risk and risk transfer <i>ex ante</i> , within the contract, and <i>ex post</i> ?
Is information provided to assess affordability, liabilities and any future commitments?
What information is available in both the public and private sectors about decision-making at contract termination?
Is information routinely available? Does the <i>Freedom of Information Act 2000</i> provide additional useful information? What information is withheld and why?

## Summary

In the context of the private sector, Millar *et al.* (2005) have argued that while institutional transparency is generally required, there is no one ideal corporate governance system. In the same way that companies choose from a range of possible corporate governance mechanisms, public authorities may design their own systems within the general framework provided by official sources and could in principle combine aspects from systems throughout the world.

This review has shown that the key purposes of corporate governance in the private sector are to control the senior decision-making body and to improve the quality of information for shareholders. The mechanisms adopted for these purposes are generic and affect the top level of the

organisation, rather than unit levels. Despite limited evidence as to their effectiveness in the private sector, these same mechanisms have been mimicked and developed in the public sector.

The review shows that *governance* of the public sector should be distinguished from private sector *corporate governance*, and argues that additional reporting and transparency are necessary to meet the demands of *governance*, especially in terms of public access to information. PPPs present particular problems and complexities: they are long-term multi stage and often bundled projects; multiple public agencies may be involved in the development, approval and management of contracts; the services are provided by numerous companies that may change over time; and they commit governments to a stream of future expenditure, affecting the sustainability of public finances, under conditions of uncertainty about future service needs. Consequently, there is public interest in the probity, stewardship, and accountability of individual long-term projects.

Although new codes for the public sector have emphasised upward accountability, documentation, data and transparency, there is little evidence about how they are working in practice. The codes however have failed to provide any guidance for downward accountability, despite the apparent focus of market reforms on the public as service users. Even more importantly, they ignore the vital issue of accountability to the public authorities by the private partners, without which neither upward nor downward accountability can be operationalised satisfactorily.

This review forms the basis for a governance-based reporting framework for downward accountability. This necessarily includes information to be derived from the private partners. From this, specific research questions for the case studies were developed.

#### ENDNOTE

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- 1 These principles are: selflessness, integrity, objectivity, accountability, openness, honesty and leadership.

# 5 FINANCIAL REPORTING OF PPP PROJECTS

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## Introduction

The purpose of this chapter is to review the institutional arrangements for the financial reporting of PPPs and the kinds of problems created by the PPP policy for reporting and disclosure from the perspective of the broader public. It therefore considers firstly the financial reporting needs of the various users of the accounts, focusing on the need to understand the cost of PPP projects to the public purse. Secondly, it examines the reporting by both the private and public sector entities within the context of current UK, EU and international accounting regulation. Thirdly, it considers the implications of this for government reporting in the form of national statistics. Fourthly, it discusses some of the broader problems raised by the use of the private sector reporting framework by the public sector. Fifthly, it reviews some of the specific problems that have arisen in the context of PPP projects, particularly the lack of disclosure that exists at many levels of reporting in both sectors. Finally there is a short summary.

## Financial reporting for the public

While the private sector accounting framework - now adopted by the public sector - is primarily reporting to the owners of the enterprise, in the public sector, in general and PPPs in particular, there are a number of stakeholders who may have an interest in the reporting of such contracts. These include the parent body such as the central, local or regional government department, the audit institution responsible for the annual audit and scrutiny, Parliament through the PAC for expenditure in general or the relevant Departmental Select Committee, and the public.

All these users have a legitimate interest in being able to understand several elements:

- the costs of contracts, particularly given the higher cost of private finance;
- the values of any reported assets and liabilities;
- the form(s) of the public sector's contribution;
- any contingent liabilities explicit or implicit in the contract; and
- the financial viability of both the projects and their operators who need to ensure that they have sufficient funds over the life of the project.

Since some projects have failed, it is necessary to monitor the private partner's financial viability and consider the potential cost of any buyback of the asset and/or debt guarantees, i.e. contingent liabilities need to be disclosed at the level of the public authority responsible for picking up the bill and, where appropriate, quantified and included in the financial statements.

The audit and scrutiny bodies such as the Audit Commission, the NAO and PAC need to understand how the contract is working in practice so that the full cost of the project is clear. Given their remit to show evidence of VFM being achieved, they need to evaluate how well the contract is performing in comparison to the full business case and the standards of performance specified in the contract, which entails the provision of non-financial performance data. They also need evidence of the full costs to the public sector, including the costs of monitoring the contract and any other additional costs generated by the PPP. At national level, the government needs clear reporting of PPPs to easily see the full cost of the PPP policy to the public purse and to enable preparation of national accounts.

As well as understanding the cost of PPPs at project and entity level, the public and government need to understand the cost at an aggregate or national level, and to determine the sustainability of public expenditure plans. Current and capital expenditure and public and private debt in relation to PPP projects therefore need to be recorded correctly in the National Accounts prepared by the Office for National Statistics (ONS). But the complexity of PPP contracts, where judgement is applied to determine what accounting treatment is appropriate, developed later in the chapter, makes this an onerous task as officers must examine the applicable financial statements from the various public authorities to extract figures on a contract by contract basis and update these annually (Chesson and Maitland-Smith, 2006).

In short, there is a need for extensive information from the public sector and also its private sector partners who are in this context *de facto* public authorities.

## **The financial reporting of PPPs**

The reporting of PPPs in the UK private sector, and therefore by implication, the public sector, is governed by the accounting regulators: the Accounting Standards Board (ASB) in the case of the UK with the International Accounting Standards Board (IASB) for consolidated accounts of listed companies since 2005. This means, as Hodges and Mellett (2002) have pointed out, that the private sector plays an important role in the public sector standard setting process. But there is also additional input from the Financial Reporting Advisory Board (FRAB) and more recently the International Public Sector Accounting Standards Board (IPSASB). The reporting within the EU varies between member states: some have their own specific rules governing PPPs, while others do not (PWC, 2005).

These regulations determine not only the financial reporting by the relevant entities, but also government statistics relating to debt, capital and

current expenditure as governed by the UN (UN, 1993) and interpreted by the EU, where the governing body is Eurostat (Eurostat, 1995). But since some countries do not have specific accounting regulations covering PPPs and Eurostat requires European wide consistency in reporting for statistical purposes, Eurostat has both contributed to the debate on accounting treatment and issued its own statement of the treatment of PPPs in national accounts (Eurostat, 2004). This has the potential to bring Eurostat into conflict with those countries, such as the UK, which have already developed their own accounting regulations. Each of these issues along with expected changes will be considered in turn.

In the UK, there are two accounting issues. First, and this is the key issue, is the nature of the PPP contract: how to determine which party has control of the asset and therefore recognizes the asset and the corresponding liability on its balance sheet. Control of the asset is dependent upon an assessment of how much risk has been transferred contractually from the public to the private sector. Initially, in the absence of further guidance, PPP infrastructure was accounted for under the *Statement of Standard Accounting Practice (SSAP) 21 Accounting for Leases and Hire Purchase Contracts* (ASC, 1984), which distinguished between operating and finance leases, which in turn determines whether an asset and its associated liability is on or off-balance sheet. This is important in determining the total amount of capital employed and debt recorded on the balance sheet.

The ASB has been generally adverse to off-balance sheet financing following accounting scandals in the late 1980s and early 1990s that stemmed from the use of leases to acquire assets off-balance sheet and thereby disguise the associated liabilities. In 1994, the ASB therefore implemented *FRS 5 Reporting the Substance of Transactions*, which required companies to recognise the economic substance rather than the legal form of transactions.

In the context of the public sector, this meant that if a public entity had ownership claims over an asset or long-term liabilities associated

with it, then the ASB expected it to show such assets and liabilities on its balance sheet. But initial Treasury guidance, later revised (TTF 1999b) indicated that most PPP projects should be shown off the government balance sheet, as the government promoted them as service contracts rather than as the provision of an asset. This was indeed how the first roads DBFO projects were initially treated (Edwards *et al.*, 2004) and implied that the government saw that much of the risk had been transferred to the private sector. This was essential in the early days at least as the government was only likely to approve projects if such risk transfer was achieved (Broadbent and Laughlin, 1999). In other words, the Treasury guidance conflicted with *FRS 5*.

But it will be recalled that in the private sector, off-balance sheet debt raised concerns about the ability of shareholders to understand the risk to which their company is exposed. Since public debt commits taxpayers to repayment, this raises similar concerns about the lack of transparency about off-balance sheet financing (Baker, 2003). Furthermore, it undermines effective parliamentary scrutiny and democratic control over the use of funds (Pallot, 1992; Newberry and Pallot, 2003; English and Guthrie, 2003).

Although the ASB stressed that it only had authority to determine accounting rules for private sector companies, it sought to resolve the conflict by adding *Application Note F* to *FRS 5* (ASB, 1998a). Recognising that these contracts might take various forms, it sought to provide guidance that would be sufficiently broad to encompass them all while remaining clear and unambiguous. This requires consideration of three factors: (i) separability of the two elements of the unitary charge; (ii) risk transfer; and (iii) quantitative risk analysis. In accordance with *Note F*, PPP infrastructure is likely to be a finance lease and recognised on the public sector balance sheet together with the associated long-term liability. Both *SSAP21* and *FRS 5* were adopted by the Government's Resource Accounting Manual without change.

While this resulted in more assets and liabilities appearing on public sector balance sheets than the government had originally envisaged, it did not resolve the issue, as in the PPP context, risk transfer is a matter of judgement. Corner, a director in the NAO, argues that it is not always clear which party should record the asset, and recommends that discussion between auditors and the audited body should take place. He notes that a mechanical application of the rules rather than a 'commonsense application of GAAP' can lead to the asymmetrical position where the asset is on neither balance sheet, as is the case in hospitals (Corner, 2006, p.52).

The second accounting issue is the value at which the asset should be recorded. *FRS 5* requires the asset and associated liability to be recognised at fair value which implies that the asset be recognised at a market value established between two willing and knowledgeable parties transacting at arm's length. However, since such a scenario is extremely unlikely in the context of most PPP assets, for example roads, an alternative is required. In the IASB's recent discussion paper on measurement bases (IASB, 2005), a hierarchy for estimating substitutes for fair value is proposed which would permit the use of models to determine an approximation for fair value. While the IASB prefers market-based models, it accepts that in their absence current or historic cost or a model, depending on entity specific expectations using data not demonstrably inconsistent with observable market expectations, may act as substitutes. In the UK, PPP assets are therefore generally recorded at construction cost.

By way of contrast to the UK position, the international debate has focused on the definition of the underlying asset and the associated liability, and this also has been problematic. There are in addition two further issues. Firstly PPPs can take a number of forms, including contractual arrangements, works concessions, service concessions and joint ventures. Secondly, the official guidance has been confusing, as some countries, such as the UK, have accounting rules relating to PPPs whilst other countries have had none, and until recently there was no

international guidance. However, there have been a number of *ad hoc* interventions on specific issues from the IASB and Eurostat.

The IASB's position is considered first. Initially, and in contrast to the UK position, regulation focused on the definition of and control over PPP assets. In the absence of specific regulation relating to PPPs, PPPs have been treated as leases and governed by *IAS 17 Leases* (IASB, 1997), which classifies leases as either finance or operating leases, dependent on the level of transfer of the risks and rewards of ownership. Given the complexity of PPP contracts, the IASB has made further direct intervention via *SIC 29 Service Concession Agreements* (IASB, 2001). This contains disclosure requirements by both private and public sector parties of: a description of the arrangement and changes during the period; significant terms that affect the amount, timing and certainty of future cash flows; the nature and extent (meaning quantity, time or amount) of rights and obligations in relation to the assets, the services provided and renewal and termination options. This is required because the IASB's *Framework for the Preparation and Presentation of Financial Statements* (IASB, 1989) states that users have a right to be able to evaluate the risks associated with future cash flows, and although this is a private sector-based rationale, such disclosure should also improve the transparency of public sector accounts.

While this deals with some aspects of PPPs, it does not provide overarching guidance. As a result of private sector concerns about the lack of guidance on how to account for PPP infrastructure, the International Financial Reporting Interpretations Committee (IFRIC) established a working group comprising representatives from Australia, France, Spain and the UK, the main member countries involved in PPP activity, to consider service concessions. The resulting interpretation, *IFRIC 12 Service Concession Agreements* (IASB, 2006) states that operators should not recognise infrastructure such as property, plant and equipment included in a service concession agreement, since the agreement does not transfer the right to control its use to the operators: the infrastructure

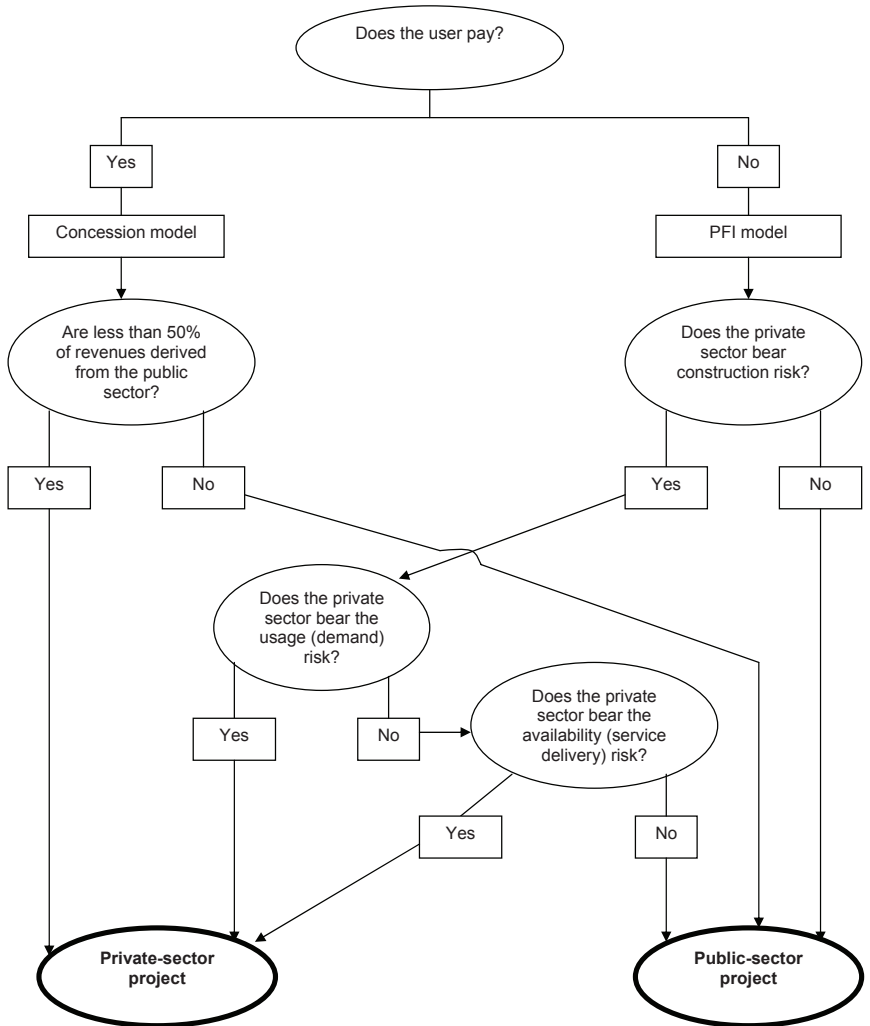
remains under the public sector's control, with the operators acting as service providers. Instead therefore, the operators should account for a financial or intangible asset so as to recognise the benefit of the right to provide services over the life of the contract. *IFRIC 12*, unlike *FRS 5 Note F*, makes the treatment dependent upon where the primary responsibility for payments lies: (i) the public sector, in which case the operator recognises a financial asset and reports it as a finance lease; or (ii) the users, in which case the operator recognises an intangible asset. While many of the responses to previous drafts of this interpretation were critical of this accounting treatment, IFRIC has confirmed its original decision. Thus, internationally, as in the UK, accounting regulators appear to be concerned that assets and the associated debts should be recognised on public sector balance sheets.

But there is a further problem. Since it is unclear when IFRSs on service concessions will apply to the public sector, there is little guidance on how to account for such transactions. Whilst IPSASB has started its own project on service concession arrangements, it has not considered other types of PPPs. Therefore, by default, the only extant guidance for the public sector in accounting for PPPs has come from Eurostat and the Committee on Monetary, Financial and Balance of Payments Statistics (Eurostat, 2004). But this was issued to clarify the treatment of assets involved in PPPs in the *European System of Accounts* (Eurostat 1995), not to provide guidance for those preparing financial statements. There is, therefore, no requirement that accounting rules for other purposes should follow suit. Indeed, its interpretation in the context of financial statements has been described as problematic for member states (PWC, 2004a).

In relation to the classification of partnerships raised in chapter three, Eurostat adopts a risk-based approach and argues that assets in a PPP can only be considered as non-governmental if there is strong evidence that the partner bears most of the construction risk and either the availability or demand risk (Figure 5.1). However, Hall (2005) has

argued that in practice these guidelines will facilitate off public sector balance sheet accounting and that this is intentional, because the EU authorities are in favour of PPPs and see them as a way of enabling the investment that industry wants that governments, constrained by the EU's own fiscal rules, could not otherwise provide. PWC's preference is that assets should be off the public sector's balance sheet to encourage the use of PPPs (PWC 2005).

Figure 5.1 Decision tree for Eurostat Balance Sheet treatment



## National Accounts and PPPs

The complexity of accounting for PPPs impacts on the compilation of the National Accounts by the ONS in relation to the identification and calculation of public and private debt, public and private investment and general government current expenditure. Firstly, ONS's current methodology relies on accounting judgements on whether the project is on or off the public entity's balance sheet. At present, only 590 projects are recorded on the Treasury database, although the 2007 Budget statement states that there are 800 signed deals. Of these 590 projects, 77 (including the three London Underground PPPs) are recorded as being on balance sheet with a capital value of £24.3bn, whilst the 513 off-balance sheet projects have a capital value of £29.1bn (Treasury, 2006a). However, different capital values are reported across different websites, making it difficult to know which is the most robust figure. Secondly, when the IFRS accounting rule changes are adopted for Resource Accounts, which may bring all schemes on balance sheet, ONS's current interim position may change. Each of these issues is discussed in turn.

### Compilation of National Accounts

It is the impact of PPP on public sector net debt that has attracted the most attention. The decision as to whether a specific project is to be treated as on or off the public sector balance sheet is made according to the regulations described above. Off-balance sheet schemes have no direct impact on public debt, although they do have an indirect effect, since any public sector payments made under them reduce cash assets or necessitate further borrowing to finance the payments. On balance sheet schemes are accounted for in accordance with UK GAAP (as adapted for the public sector by HM Treasury), the *European System of Accounts* (Eurostat, 1995) and the *System of National Accounts* (UN, 1993). This

means that when asset construction is completed, the capital investment is recorded as an asset at an amount equal to the value of the contract, less residual value. On balance sheet schemes are treated as finance leases, where the debt is recorded at the value of the outstanding capital amount that will diminish over time as capital repayments are made.

Prior to 2005, public sector net debt (PSND) was understated, because the finance lease debt for operational on balance sheet projects was not included (Chesson and Maitland-Smith, 2006). As the ONS must calculate the imputed finance lease debt separately for each project, this is an extremely time consuming exercise. The ONS was unable to include this figure within the PSND without going to the original source material, the audited public sector accounts comprising central government departmental resource accounts, public corporations' financial statements and local authority accounts. Where the accounts provide only aggregated information, as in Highways, the ONS now requests itemised information. The ONS work initially added an estimated imputed finance lease debt for PPP projects of £4.95bn at March 2006 (Chesson and Maitland-Smith, 2006 p.27). In making the decision to include this figure, the ONS has followed UK accounting guidance as laid out above, as well as the Eurostat *Manual on General Government Deficit and Debt*.

But there is a further complication. In order to make the initial calculations for the imputed finance lease debt, the ONS has had to examine accounts dating back to the start of the project, 1999/2000 for central government and as far back as 1987 for public corporations. As the ONS found it difficult to obtain all the necessary local authority accounts, it had to scale up some estimated figures, although these are trivial relative to central government and public corporation amounts. The detail with which Chesson and Maitland-Smith (2006) describe the procedure to develop monthly and quarterly figures using interpolation, extrapolation and adjustments shows just how complicated and time consuming this process has been.

The inclusion of the imputed finance lease debt for on balance sheet schemes is however only part of the story. For completeness, the ONS needs to record private sector debt for schemes which are off public sector balance sheet. This requires a list of SPVs and their PPP related debt, which does not exist. Furthermore, the ONS carries out its monthly and quarterly inquiry work in relation to the private sector, via sampling based on employee numbers. But since the SPVs are shell companies with few or no employees, they fall below the ONS threshold. It is therefore unclear whether the ONS estimate of private sector debt is accurate.

A final problem is due to the asymmetry in the treatment of the PPP asset by the public and private sectors. Some schemes, such as most hospitals, which are off-balance sheet in both sectors are not included at all, whilst those schemes such as roads which are on balance sheet in both sectors, are double counted. While the ONS recognises that it has a problem here, it has as yet been unable to find a solution (Chesson and Maitland-Smith, 2006). It is therefore unclear whether hospitals for example show up in the figures for private debt, how many projects are implicated and what the financial effect might be.

These same issues apply in categorising PPP capital investment as either public or private investment (capital expenditure). The capital expenditure for on balance sheet schemes is added to public sector capital expenditure once the construction phase is completed (whether in whole or for part of an asset). The value recorded is the capital value of the asset which may be more than the associated debt, less any residual value.

The final way that PPP impacts on national statistics is on the government's annual current expenditure. For on balance sheet schemes, the ONS includes the unitary charge payments and the interest payments on the imputed finance leases. For off-balance sheet schemes, the only current expenditure is the unitary charge.

## Future changes

*IFRIC 12* implies that the public sector should recognise infrastructure included in a service concession agreement as an asset on its balance sheet. The UK will apply IFRSs, adapted for the public sector, from April 2009 (Treasury, 2008a) and is currently seeking comments on the accounting treatment of PPP arrangements for the IFRS-based Government Financial Reporting Manual (FRAB, 2007; Treasury, 2008b). Under current proposals many more PPP schemes will come on balance sheet, with one estimate (*Financial Times*, 26/07/07) of the effect being around £30bn of PPP borrowing. All this will make the ONS' task more difficult because this requires the process explained earlier to be replicated for all PPP schemes.

While it does not follow that this will increase either current expenditure or Public Sector Net Debt, which is based upon National Accounts concepts that are not affected by the change in GAAP standards to IFRS, public sector investment will increase relative to private sector investment debt. For individual public bodies, there will be a further cost: the capital charges to be paid on the increased value of their assets.

Taken together, this means that there is a potential in the future for conflict between international GAAP in the form of *IFRIC 12*, the ONS classification and Eurostat. The UK public sector, which uses resource accounting, is expected to bring most schemes on balance sheet, increasing public investment and debt, while ONS is continuing to use a different measure for Public Sector Net Debt which may omit some schemes. Although Eurostat appears to bring assets on balance sheet, as Figure 5.1 shows, there is enough ambiguity in the regulations to mean that this can be circumvented. This mismatch between the different conventions is likely to be reflected in other European countries as *IFRIC 12* is implemented.

## Limitations of using the private sector reporting framework in the public sector

The public sector has adopted private sector financial management including accruals-based accounting, which requires assets and their corresponding liabilities to be defined and valued, and the requirement to generate a rate of return on capital employed. However, the transfer of such norms and values into the public sector is problematic for a number of reasons (Pallot, 1992).

Firstly, the shift to financial management, with its emphasis on efficiency and market principles, has brought with it a range of accounting regulations whose objectives are based on the decision-usefulness perspective of the private sector, where shareholders seek to determine whether to buy, hold or sell their shares in the entity. Secondly, the valuation of public infrastructure assets is complex and non-standard, necessitating a wider view of resources and cost-benefits assessment than the private sector emphasis on future cash flows. At the very least, public sector objectives include service delivery and social policy objectives as well as financial objectives. This means that assets may be a store of future resources rather than a means to generate cash flow. Thirdly, since it is impossible to separate performance assessment from service objectives, non-financial disclosure is needed as well, entailing more comprehensive financial statements to meet the needs of service users and citizens who are otherwise unable to demand specific financial information (IPSASB, 2006).

Fourthly, the emphasis on a business approach has meant a move away from a 'civic culture' to a 'business culture' (Broadbent *et al.*, 1996, p.261), with the concomitant switch away from a complex and multiple set of relationships between stakeholders within government and in the community to the simple two-way principal-agent model that underpins accountability in the private sector. But this type of managerial accountability emphasising upwards accountability to

Ministers, paralleling managerial reporting to shareholders where the Treasury, at least implicitly, is treated as a shareholder in the public authority that seeks a rate of return, is insufficient in the public sector. There, a much wider public accountability is required to parliament and the community at large (Pallot, 1991a; Rutherford, 2003; Newberry and Pallot, 2003; Wynne, 2004). On this point, Pallot argues (1991b) that accountability based simply on rights and contracts is incomplete, and only a move towards social responsibility accounting, which would consider principles such as need and equality, can ensure fairness for all stakeholders.

Finally, since the monitoring of actual against budgeted expenditure is no longer uniformly publicly reported, the scope of financial reporting is narrower than necessary to meet the needs of users. The tradition of budget reporting and the monitoring of actual against budgeted expenditure needs to be reinstated to ensure compliance with parliamentary authorisation, central government oversight, and public transparency. IPSASB claims that this, plus the adoption of International Public Sector Accounting Standards (IPSAS), should lead to increased transparency and accountability (IPSASB, 2006).

## **Reporting problems in the context of PPPs**

Edwards *et al.* (2004), in their analysis of reporting practices in the context of UK road and hospital PPPs, raise several reporting and disclosure issues that are relevant here. They note that disclosure about PPPs by the public authority is very limited. In part, this may be due to the size of the project relative to the reporting entity. In the case of roads, prior to the introduction of resource accounting, the payments were not disclosed at all. Subsequently, since the sums are only a small proportion of the overall spend, information is aggregated rather than given on a road by road basis. No identifiable information is reported in the primary statements, as figures are subsumed under headings of

operating and finance expenses in the profit and loss account and, for on balance sheet schemes, assets and obligations under finance leases in the balance sheet. But in the case of hospital Trusts, where there will typically only be one PFI hospital to report, the full unitary charge is given in a note to the accounts, as this is a significant proportion of expenses for the Trust. For on balance sheet schemes, interest on finance leases is shown under the breakdown of interest payable and the amount of assets acquired through finance leases, and the diminishing outstanding capital obligations are disclosed.

Edwards *et al.* (2004) argue that at least three further sets of information are needed to understand the cost of the PPP. These include the breakdown of the unitary charge between the availability and service elements, the amount of any performance deductions in each service area, and the public entity's costs of monitoring the project and an explanation of why that actual cost differs from that expected and set out the previous year. This would permit an understanding of the full cost of the project and a comparison of the actual and expected cost as set out in the case for using private finance.

Hodges and Mellet (2004) have identified a further problem. The difference in treatment of the underlying asset in the same sector, for example hospitals, makes it difficult for users of public sector accounts to interpret the financial performance and to understand how public services have been financed.

As *de facto* public authorities, the private partners' reporting is also important. But that too is constrained by regulation. Despite that, the current limitations of the public sector's reporting mean that stakeholders must rely on the SPV's accounts to obtain some of the necessary information about payments and costs, to hold decision-makers to account for the use of public money and the stewardship of assets. This is because the SPV services only the one contract which therefore provides its sole income stream, and therefore the financial statements potentially provide some information about income,

expenses, refinancing arrangements and balance sheet movements. But this too is problematic.

Firstly, the private sector, governed only by private sector reporting regulations, does not report costs against individual service headings. Secondly, and more importantly, the SPVs subcontract to their sister companies, much larger entities with multiple sources of income. Since they operate as close companies, they are not usually required to produce cash flow statements. More significantly from the perspective of this study, they are not required to report the size of transactions with their sister companies, making it impossible to trace cost, including the total financing costs, and responsibility through the extended supply chain.

Thirdly, there is asymmetrical reporting of payments by the public agency and of receipts by the SPV. Some of the differences, but not all, between the amounts reported as payments by, for example, the Highways Agency and those shown as revenue by the SPVs, can be explained by differences in year end date and the inclusion of value added tax on the Highways Agency's payments. This lack of symmetry is important because since the public sector does not always report its costs on a per project basis, this means that there is no consistent way of finding out the payments on individual projects. It is interesting to note the FRAB (2005) argued that it would prefer symmetrical treatment.

A fourth problem relates to the not infrequent restructuring of the private partners which makes it impossible to trace the payments from public sector to a private sector partner on a consistent basis.

A fifth issue is that of contingent liabilities. From a public interest perspective, this entails identifying any major risks, such as default, and the probability and cost of such a risk crystallising. This arises because as PWC (2004a) note, the private sector will seek to mitigate risk (and reduce costs) by taking advantage of the credit worthiness of the public authority (or its parent body) responsible for the future payments. Thus governments may offer explicit or implicit guarantees to protect concessionaires' receipts. For example, in the case of the London

Underground PPPs, TfL guarantees 95% of its private partners' approved debt. Furthermore, the DfT provided TfL with a letter of support stating that should London Underground run into financial difficulties because of its PPP contracts, it would consider what financial support it would give. The DfT made the point that it would be untenable for it to simply stand back and do nothing. Thus, there is support from two public bodies. While the information is in the public domain, this is because both are disclosed by London Underground to the capital markets in the context of a public bond.

*FRS 5* makes clear in paragraph F51 that any such obligations are to be accounted for in accordance with *FRC 12 Provisions, Contingent Liabilities and Contingent Assets* (ASB, 1998b). That is, contingent liabilities should be reported in a note to the accounts unless there is only a remote possibility that they will fall due, in which case they are not reported at all. The EU (EMU, 2003) and international codes of fiscal transparency, for example, the OECD best practice for budget transparency (OECD, 2001), recommend the inclusion where possible of quantitative information on contingent liabilities on the balance sheet. PwC, on the other hand, appear to argue against such reporting, urging that national accounting rules should not stand in the way of PPP solutions 'as a result of an inappropriate accounting treatment of guarantees' (PwC, 2004b, p.19).

While the scale of public support in the case of London Underground is large and widely known to those with an interest in these matters, it is not clear that such implicit or explicit support is uniformly disclosed. In most cases, contingent liabilities are not reported at all, indicating that the public sector considers that the likelihood of contract failure and liability returning to the public sector is remote. For example, despite the fact that the government apparently guarantees the Highways Agency's payments on the contracts (Standard and Poor's, 2003), accounting for such guarantees is not visible in the public sector accounts. Such omissions may however be optimistic as there have been

a number of UK cases where the liabilities have unexpectedly crystallised. The government has either bailed out or given substantial additional subsidies and grants to a number of PPP type projects, for example, the Royal Armouries Museum, the Channel Tunnel Rail Link and National Air Traffic Services. The essential nature of public services means that government must step in to avoid failure as it bears the political and reputational risks. Hence experience shows that the judgements that such contingent liabilities were unlikely to crystallise were incorrect and therefore the continuing failure to disclose such obligations as contingent liabilities is inappropriate.

Such contingent liabilities are not reported by the ONS until either they have occurred or a separate decision to classify the private company as a public authority for national statistics purposes has been taken. Such a decision is a reflection of a correlation between the size of any guarantees and the public sector's control over the organisation, which determines the classification of public versus private debt. This then may lead to classifying the private entity as a public authority as in the case of London and Continental Railway, the company managing the Channel Tunnel Rail Link, and Tube Lines and Metronet, the companies managing the London Underground PPPs.

A sixth issue is that of ring fencing of the private sector's front loaded revenue streams to ensure that funds will be available in the future to cover maintenance expenditure. The Treasury's model contract for PPP construction projects (Treasury, 2007b) indicates that in theory a sinking fund will be built up over the years to pay for planned maintenance work in the future. However, not only has the public authority no right to specify the size, location or availability of such a fund, it is difficult for the public to determine if and where such funds actually exist since there is no requirement to hold the sinking fund within the SPV rather than in another related company.

But there is a further issue. Edwards *et al.* (2004) report an example where the SPV incurs a liability on behalf of its parent by taking out a

loan which it then transferred to its parent companies on an undated interest-free basis. In other words, the SPV has increased its own costs and risks for the benefit of its parents.

## Summary

This chapter has argued that the public needs to be able to understand: (i) the costs of contracts; (ii) the values of any reported assets and liabilities, including contingent liabilities; (iii) any public subventions; and (iv) the financial viability of both the projects and their operators. This has implications for disclosure by all parties to the transaction. However, the adoption by the public sector of the private sector reporting framework means that accounting regulation does not require the disclosure of much of the necessary information by all the relevant parties. By contrast, Stock Exchange regulation does require reporting of some additional information. This results in information being disclosed to the capital markets and in documents that the public might not know of or find.

Furthermore, much of the required disclosure is limited in its usefulness. Some of the key judgemental decisions, for example on risk transfer and contingent liability, would benefit from an explanation since the decisions may be finely balanced, leading to different interpretations by the different parties. This in turn gives rise to a lack of reporting symmetry both between the partners and between and within agencies for similar contracts.

The IASB's IFRSs are aimed at standardising international treatment and disclosure and are to be implemented in the UK public sector. This is to be welcomed for the reporting of PPP contracts. However both the IASB and IPSASB are still developing standards that will impact on PPPs. Furthermore, it is unclear whether Eurostat's ruling on the reporting of the underlying asset for national statistics purposes will perpetuate the ambiguities and inconsistencies. The complexities of PPP

reporting have also made it difficult for the ONS to provide complete figures in respect of government debt, while contingent liabilities are not adequately identified and reported. This means that it is impossible to obtain an accurate picture of the sustainability of public debt and expenditure.

# 6 THE RESEARCH APPROACH

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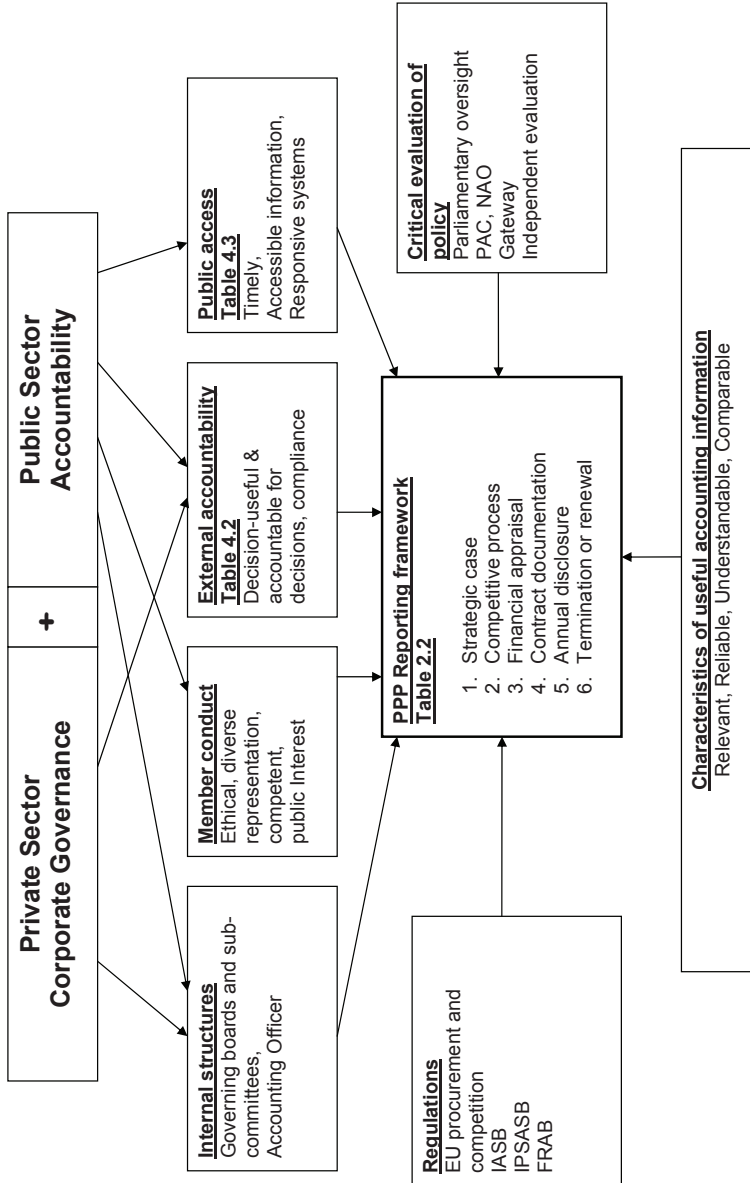
## Introduction

The purpose of this chapter is to describe the governance-based reporting framework used to analyse the cases, the cases chosen, the data sources, the information routinely put in the public domain, and the means of and difficulties in acquiring additional information via the *Freedom of Information Act 2000* and the *Audit Commission Act 1998*. Finally, there is a short summary.

## A governance-based reporting framework

Chapter two has examined the nature of PPP projects, and chapters three, four and five considered their governance and reporting environment. Figure 6.1 draws together the elements of a governance-based reporting framework, which will be used to guide the empirical analysis of the six stages of the cases.

Figure 6.1 Governance-based reporting framework



As Figure 6.1 shows, all parties operate under conditions where there are private sector corporate governance and decision-usefulness and public sector accountability requirements to be fulfilled. That is, the four elements of governance apply not only to the public sector entity, but also, to at least some extent, to the private sector partners.

Chapters three and five identified international and national influences. As shown in Figure 6.1, these come from the EU in terms of procurement and competition, the IASB and IPSASB in terms of reporting, as well as national regulations from FRAB, and variously affect each of the six stages of PPP contracts identified in chapter two. While EU procurement and competition regulation impacts particularly on the procurement process, it also affects the operation phase, as contract amendments occur throughout the life of the project, as well as potentially at the termination/renewal stage. Furthermore, while regulation from the IASB will most directly impact on the annual reporting during the operation phase, it may also indirectly impact on earlier stages to the extent that contracts are written to satisfy particular accounting requirements, especially in relation to risk transfer.

Since the focus of this study is on reporting and accountability - the public access and external accountability elements of governance rather than the more generic issues of internal structures and ethical behaviour. Thus it is pertinent to consider the nature of useful reporting. Accounting regulators in different countries and the IASB have developed conceptual frameworks of accounting that seek to identify in general terms the users of financial statements and their information needs. The international framework (IASC, 1989), adopted in 2002, identifies several principal classes of user: present and potential investors, lenders, suppliers and other trade creditors, employees, customers, governments and their agencies, and the general public. However, the framework assumes that these stakeholder groups have a common interest in understanding the ability of the entity to generate cash and the timing and certainty of future cash flows. The framework specifies that financial statements that

meet the needs of the providers of risk capital will also meet most of the general financial information needs of the other classes of user.

However, Tinker *et al.* (1982) argue in the context of corporate accountability that this consensus-building approach may not be universally beneficial or appropriate, since accounting disclosure has a role as 'social adjudicator' and is biased in favour of one particular social class – the shareholder (Cooper and Sherer, 1984). Furthermore, in the context of the public sector, the IASB's view is disputed by the IPSASB (2006). IPSASB states that more comprehensive financial statements are required for service users and citizens, who are otherwise unable to demand specific financial information. While this is undoubtedly true, even this leaves out the greater complexities of and requirements that flow from PPPs.

The IASB framework, which is broadly similar to that of other regulators, identifies four principal qualitative characteristics of useful accounting information, as shown in Figure 6.1: understandable; relevant, which includes being material and timely; reliable, which includes representational faithfulness, substance over form, neutrality, prudence and completeness; and comparable. While *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*, established the supremacy of the relevance and reliability qualities, there may be a trade-off between these two qualities. Furthermore, accounting information should enable investors to take decisions. However, since such decisions necessarily have a forward looking emphasis, whereas financial statements refer to the past, it is far from clear that financial statements meet the needs of investors, let alone other stakeholders.

The final influences on public sector governance, shown in Figure 6.1, are the oversight and evaluation processes. Broadbent and Laughlin (1997) argue that if accountability is to be achieved then government must critically evaluate, not merely justify, actions. In the UK, as in many other democracies, there is a Parliamentary oversight process which may be capable of such evaluation, although, as outlined in chapter four, the literature suggests this may have its limitations. In addition,

independent critical evaluation must be possible if accountability is to be achieved. That is, sufficient information must be publicly accessible to permit independent evaluation.

## The cases

In order to examine the degree to which the actual disclosures and reporting by the various parties corresponds with this reporting framework, six projects were chosen from the DfT's list of 22 sponsored/signed deals for road projects, worth £3bn in January 2005 (DfT, 2005), to review in detail. However, the department's list was neither complete nor consistent with the list provided by the Treasury (2006a) for the comparable period and is now no longer published, but subsumed within the Treasury's database. Neither list included the Skye Bridge, one of the earliest and most controversial, although other Scottish projects were shown on the DfT's website and the Skye Bridge is treated as a PPP project in the Scottish Executive's consolidated accounts. However, this could be because the project had terminated by this date.

The six have a capital value of £1.3bn, equal to just under half the value of total road projects signed, reflect the type, value and spread of agencies involved in managing the projects, and are shown in Table 6.1. The projects are managed by different types of public agencies and embrace a variety of different types of financing and funding regimes, some of whose contracts have run their course, been terminated, or are still ongoing. The cases fall into two categories: the three free standing projects with user charges, negotiated by the DfT and the Scottish Office, and the three DBFO projects paid for out of taxpayers' money and managed by regional or local authorities. A further scheme, the Forth Bridge, wholly financed by the public sector, is included for comparison purposes.

Table 6.1 Case studies

Name of project	Public sector procuring agency	Public sector managing agency	Contract signed	Operational
Dartford Crossing (phase I DBFO)	Department of Transport	Department of Transport/ Highways Agency	April 1987	1991 Terminated March 2003
Skye Bridge	Scottish Office	Scottish Executive/ Transport Scotland	June 1991	1995 Terminated Dec 2004
M6 Toll Road	Department of Transport	Highways Agency	February 1992  Link road (announced May 2006)	December 2003  Not built yet
A74(M)/ M74	Scottish Office	Scottish Executive/ Transport Scotland	April 1997	1999
A55 Wales	Department of Transport/ Highways Agency	Transport Wales	December 1998	March 2001
A13 Thames Gateway	Department of Transport/ Highways Agency	Transport for London (inherited it July 2003)	April 2000	Improvements substantially complete summer 2004
Forth Bridge	Forth Bridge Joint Board	Forth Bridge Joint Board	Building began in 1958	1964

Table 6.1 Case studies (continued)

Name of project	Type of contract	Capital value	Annual payment by public sector	Private sector company
Dartford Crossing (phase I DBFO)	Concession with user charges	QE Bridge £180m plus debt on pre-existing crossings of £43.5m	None	Dartford River Crossing Ltd
Skye Bridge	Concession with user charges and government contribution to capital costs and subsidies to users	Not reported by Department for Transport, £39m by NAO but SBC shows £30m and Department for Transport's costs were £14.6m (NAO)	Subsidies and VAT after 1987	Skye Bridge Company
M6 Toll Road	Concession with user charges  Contract to build a link road bringing traffic to M6 following refinancing	£485m in 1992, or £680m in 2006 prices £700m in accounts as asset value Company states capital value of project as £900m on web site  Company and Gov imply cost is £112m	None	Midland Expressway Ltd
A74(M)/M74	DBFO with shadow tolls	£96m capital cost	£21m pa	Autolink Concessionaires plc
A55 Wales	DBFO with shadow tolls	£100m	£16m pa	UK Highways A55 Ltd
A13 Thames Gateway	DBFO with shadow tolls/availability fee	HA project valuation says £128m, elsewhere says £146m Treasury says £229m and PUK/DfT say £411m	About £11m pa	Road Management Services Ltd
Forth Bridge	Public sector build and operation with user charges	£14.5m	None	Not applicable

The first of the three free standing projects, the Dartford Crossings, involved a private sector consortium building a new £180m bridge (Treasury 2006a), the Queen Elizabeth II Bridge, across the Thames to complement the two Dartford Tunnels and cope with the increase in traffic from the M25 that opened in 1986, for the DoT. The concession involved firstly building, operating and maintaining the bridge, which would be tolled, and secondly transferring the two tunnels and their associated revenues and liabilities to the consortium. The tunnels had cost £13m and £45m respectively to build, had been run by two local authorities and were already tolled. The first tunnel had been fully paid for, but the more recent tunnel carried a debt of £43.5m. In other words, the concession would manage and receive revenues for the three crossings while paying for the construction and financing costs of two. The concession was awarded for up to 20 years from 1988 and the bridge became operational in 1991. It would terminate when the tolls had covered the cost of the bridge, including its financing. As traffic flows were higher than expected, all financial commitments were completed ahead of schedule in 2002, although the consortium continued to run it on a management-only basis for a further year, when the concession terminated. Under legislation enacted in 2000, the Crossings would be transferred to the Secretary of State for Transport, who extended the tolling. A new concession has since been awarded to a different concessionaire on a management-only basis. This study considers only the construction and operation contract up to 2004.

The second, the Skye Bridge project, signed in 1991, involved the private sector building a bridge to link the sparsely populated island of Skye to the Scottish mainland, with a £15m contribution from the Scottish Office to cover the cost of the approach roads. The bridge would be tolled and the concession would last until either the revenues had reached £23.6m discounted at 6% to 1991 prices or 27 years, whichever was sooner. The total cost of £39m, including the construction cost of £20m, £4m for operating costs and £15m from the government for the

approach roads, was more than expected. The Skye Bridge opened to traffic in 1995. But with low traffic volumes, toll charges were high. As a result of public protest at the charges, the highest in Europe per kilometre of road, the Scottish Office, later the Scottish Executive, subsidised the tolls, paid the VAT charges and later terminated the contract in 2004 at a cost of almost £27m.

The third project, the M6 toll road, signed in 1992, involved the private sector financing, building, operating and maintaining of a new 27 mile stretch of motorway, variously listed as costing £450-900m. This would be Britain's first tolled road and the concession would last for 53 years. The road opened in 2003 and has seen low traffic volumes, widely understood to be lower than expected. The company, now owned by Macquarie Infrastructure Group (MIG), refinanced its loans in 2006 with a larger loan which it used to repay the original loan and make a £300m payment to its parent company. It came to a voluntary agreement with the Highways Agency to share some of the refinancing gains by building a link road, untolled, between the M54 and the M6 and M6 Toll Road, and carrying out some other improvements, at a cost of £112m. This road, to be built free of charge to the state, will generate further traffic and revenue for the toll road.

The three DBFO projects, the A74(M)/M74 later known as the M6, but referred to in this report as the A74M/M74 to avoid confusion with the M6 toll road, the A55 and the A13 were essentially upgrades of existing roads with the operation and maintenance of further stretches of road totalling 120kms, 32kms and 20kms respectively. While negotiated and signed at the national level, they were later transferred to regional or local governments to manage: the Scottish Executive; the Welsh Assembly; and TfL, respectively. The total construction costs were about £96m, £100m and £229m respectively (Treasury 2006a). Annual payments by the public authorities were expected to be about £21m, £16m and £12m per annum respectively for 30 years, reflecting the length of road that would need maintaining in the future. The

payments were made on the basis of usage (shadow tolls) and, in the case of the A13, availability and the safety performance of the road as well as shadow tolls.

A final case is the publicly procured and managed Forth Bridge across the Firth of Forth, a major artery linking Fife to Lothian and Edinburgh, opened in 1964, which is included for comparison purposes. The £14.5m funding for the construction of the bridge and approach roads came from three public sector sources: a £4.7m grant and £9.3m loan from the Secretary of State for Scotland, and £0.5m from six Scottish local authorities. Additional loans totalling about £5m were made by the Secretary of State throughout the 1960s. The bridge was to be tolled to cover the cost and maintenance of the road until 1995, the expected date of debt repayment.

Unlike the six privately financed projects, the Forth Road Bridge Joint Board was established by statute as the authority responsible for the original construction, maintenance and operation of the bridge, with 16 members drawn from seven local authorities. In 2002, the Board was reconstituted as the Forth Estuary Transport Authority (FETA) and its composition and responsibilities were modified. FETA's responsibilities were widened from the management, maintenance and operation of the bridge, to include the development, support and funding of appropriate schemes to reduce traffic congestion on the bridge or to encourage increased use of alternative public transport systems.

In its first year of operation, the bridge carried 4m vehicles compared with less than 1m previously carried by the ferries. Its annual traffic volumes are now around 24m, far in excess of its theoretical capacity since 1997. Hence toll revenues have exceeded expectations. Although the debt was in fact repaid a year ahead of schedule in 1994, tolling - like the Dartford Crossings - was extended. However, after the 2007 election, the Scottish government announced the termination of tolls for the Forth Bridge.

## Data and sources

For each project information was sought, as per the reporting framework outlined in Table 2.2, for:

- the decision-making process, via the strategic business case, the competitive process, the financial appraisal, contract documentation and any official reports;
- the operational phase, via the annual report and accounts of both the public and private sector partners, any official and regulatory reports, any *ex post facto* formative evaluations and project reviews; and
- the termination arrangements and any summative evaluations.

This entailed a search of the public authorities' websites, their publications list, the websites of the official watchdogs, media coverage, the corporate press, and other related sources for such information. Their annual report and accounts were obtained directly from the public agency or its website and from Companies House in the case of the private sector companies. Since the strategic business cases, public sector comparator, contract documents and evaluations were not publicly available, such documents were sought under the *Freedom of Information Act 2000* or the *Audit Commission Act 1998* and subsequent secondary legislation which provides statutory rights of inspection in local authorities during the annual audit. In some cases, additional information was sought from both the public and the private sectors in order to clarify particular points or procedures, via email or telephone, as well as face to face discussions.

The information routinely put in the public domain is considered first, and then the means of and difficulties in acquiring additional information.

## Information routinely placed in the public domain

Firstly, one of the most striking findings is how little financial information in relation to each of the six phases of the project is routinely provided by the procuring agencies. The public is almost entirely dependent upon a project summary available on the authority or other public agency websites and various reports describing some of the key features of the project. Secondly, while the availability of such information has improved in recent years as a result of the internet and the *Freedom of Information Act 2000*, this is nevertheless very limited with respect to both the amount of financial information and its accuracy and timeliness. Some information that is disclosed, such as the capital value of the project, differs across government websites. Thirdly, the amount of information available has increased between the start of this study in August 2005, when data was initially collected, and the writing of this report in late 2007. Fourthly, although the public authorities may make the information available, it is not always very accessible or in a consistent place from year to year. While the Welsh Assembly has a very easy to use website, others are more opaque, requiring telephone calls to helpdesks to locate information. This failure to provide such information in a consistent form and location contrasts with the private sector, which typically places its financial statements and any corporate plans in a location labelled ‘investor relations’.

As Table 6.2 shows, the public authorities do not routinely release information relating to the procurement decision either contemporaneously or *ex post*. This means that the original strategic case setting out the reasons and detailed justification for the project, information setting out how competitive tension was achieved, the financial case for using private as opposed to public finance otherwise known as the Public Sector Comparator (PSC), and the contracts are not in the public domain. The practice appears to differ across sectors, as the hospital Trusts do routinely put their strategic business case and

financial appraisal of their PPP projects into the public domain after financial close.

In the case of the annual disclosure of the operational phase, the public authorities do not systematically present information about the operational and financial costs and performance of their road projects, including risk sharing, monitoring costs and any internal reviews, and overall evaluation after contract termination. In some cases, this is simply a dissemination issue, that is, the public authorities provide some information, but it is difficult to find it. In other cases, although some information is discovered incidentally via the financial press or questions in parliament, this is neither systematic nor easily accessible. But most of this information is not publicly available. While the public authority reports its financial transactions relating to its private finance contracts in its annual report and accounts, since there may be several such contracts and the amounts may be small relative to the overall expenditure, the costs of individual projects are usually invisible.

Table 6.2 *Information disclosure*

Name of project	Strategic analysis	Competitive process	Case for private finance with public sector comparator
Dartford (Toll)	Refused under FoI	No information available	PSC not required
Skye Bridge (Toll)	Background from NAO/PAC	NAO/PAC reports	No PSC done Some info from NAO/PAC reports
M6 Toll Road	Never published despite legal case/ inquiry Refused under FoI	No information available	Refused PSC/business case under FoI
DBFO A74(M)/M74	Strategy report provided under FoI	NAO provides some info	Some info from NAO report
DBFO A 55	Not provided	No information available	PSC (FoI)
DBFO A 13	Not provided	No information available	PSC dated March 1999 provided under <i>Audit Commission Act</i> and FoI
Forth Bridge public sector	Not available	Not available	Not applicable

Table 6.2 Information disclosure (continued)

Name of project	Contractual arrangements	Operational phase	Termination
Dartford (Toll)	Some contractual info (FoI)	Provided info re traffic flows and charges No monitoring costs Public sector accounts not applicable Private sector accounts	Only via private sector accounts but no winding up accounts No summative review
Skye Bridge (Toll)	NAO report Contract (FoI)	Financial info (FoI) No monitoring costs Toll reviews Public sector accounts Private sector accounts	Financial arrangements from Scottish Executive No winding up accounts from private sector No summative evaluation
M6 Toll Road	Redacted contract (FoI) Refused contract for additional road (FoI)	Two traffic impact assessments No monitoring costs Public sector accounts Private sector accounts	Not applicable
DBFO A74(M)/M74	Contract (FoI)	Short review by Scottish Exec No monitoring costs Public sector accounts-aggregated so invisible Private sector accounts	Not applicable
DBFO A 55	Contract (FoI)	Provided detailed info on costs, monitoring costs etc (FoI) Public sector accounts-aggregated so invisible Private sector accounts	Not applicable
DBFO A 13	Provided (AC and FoI)	Provided some financial info Public sector accounts-aggregated so invisible Private sector accounts	Not applicable
Forth Bridge public sector	Not applicable	Detailed financial accounts with wide range of info	Not applicable

Although the private sector companies provide financial statements, their corporate structure (SPV) is such that they provide very little information. The SPVs typically have no employees and subcontract to their sister companies. But as subsidiaries of far larger companies, they operate as close companies that are not required to provide details about the scale of the transactions with their sister companies. Even where they do, unless the sister company is also entirely dependent upon the one contract, it is impossible to track public sector monies through the extended supply chain. Thus they disclose very little information about the costs or overall profits of their contract with the public sector.

By contrast, although FETA also does not provide information relating to the pre-operational phase since the bridge is more than 40 years old, it does provide extensive information about the operational and financial performance of the bridge on an annual basis. This is because it publishes separate accounts, described as the Report and Accounts, addressed to its parent local authorities and the auditor, the Accounts Commission for Scotland. In addition, there is a separate document, now called the Annual Report, which provides commentary and some statistical information on issues arising during the year and on future plans, and, for the last few years only, information on internal control. FETA also publishes on its web site budget information for 2007/2008, long-term capital plan figures, and the agenda and minutes from its meetings. There is also a series of publications on specific topics, for example, maintenance projects, traffic statistics and ongoing consultations.

### **Additional means of securing information**

The UK's *Freedom of Information Act 2000*, which came into force in January 2005, enables the public to make requests for information from the relevant public authorities. While the *Freedom of Information Act 2000* was expected to make the government and public authorities

more open, the Act has proved to be of limited value in the context of private finance contracts. It requires considerable persistence and insistence to obtain information. The way that public agencies respond and their helpfulness and speed of response vary enormously. In part, this is because the officials do not always understand what information is required. While some agencies will telephone to clarify what is required, others do not and simply refuse, saying that the information is not available. Not all requests were granted. Some were simply evaded. For example, some requests which were part of a list seem to have been ignored. A not infrequent response was that the document(s) were not available, with no explanation as to what that meant, such as never written, or no longer stored. Lastly, to find out about some issues such as the competitive process may require numerous documents, none of which have a specific name, making them difficult to locate, particularly if they are very old.

More importantly, the *Freedom of Information Act 2000* proved to be of limited value because the Act allows public authorities to refuse to disclose information. Firstly, they may refuse on the grounds that such information is 'commercially sensitive'. Since some do provide the information, this only begs the question why such information is commercially sensitive in some authorities and not in others. In some cases, the public authorities released the information requested, but with significant parts, e.g. termination clauses, redacted. Secondly, they may refuse because it would cost the public agency too much to provide the information. In one case, the agency refused all requests for information on the grounds of cost, even though the requests were for three specific named documents. Similarly, it can be difficult to obtain information unless there is one specific document since this inevitably comes up against the cost rule. Multiple requests for information in one letter also invoke the cost rule.

Requests to the Welsh authorities were dealt with speedily and efficiently. Scotland has a separate Act with some important differences

that are generally superior in terms of people's right to know. Scotland also has a stronger and more pro-active and efficient Information Commissioner and a greater level of scrutiny by the Scottish Parliament and local journalists (Brooke, 2005). Together, this means that its regime is more open than the rest of the UK and requests to the Scottish authorities were more successful than to the central government and TfL.

Taken together, however, the variation between authorities was such that it was difficult to avoid the conclusion that some of them used the exemptions provided by the Act to refuse to disclose information that could quite reasonably have been provided. Indeed, had time permitted, many of the refusals or evasions could and should have been appealed.

Furthermore, it is impossible to use the *Freedom of Information Act 2000* to request information from or about the private sector partners. The Act gives the Lord Chancellor the power to designate private sector companies that deliver public services under long term contracts as public authorities, which would bring such companies or the parts of the business that do so under the jurisdiction of the Act. He has not however done so. All this contrasts starkly with the private sector's right under the *Freedom of Information Act 2000* to have information relating to the contracts and reasons for rejection or disqualification and pricing of their bids.

In the case of local government, the *Audit Commission Act 1998* and the equivalent legislation for regional authorities provide the local electorate with a mechanism to obtain information. At the end of each financial year, while the annual audit is being prepared, the public may request financial information, including information relating to private sector contracts, and question the authority's auditor. This provision does not appear to be widely publicised, known about or used. In the case of a particular local authority contract, the authority refused to proceed via this mechanism, offering instead to provide any information required on an informal basis. While it provided some contextual information, including some financial information, even this was limited, incomplete

and did not match information that has now become publicly available elsewhere. It took more than a year to obtain the PSC and contract documentation using both this avenue and the *Freedom of Information Act 2000*.

## Summary

This chapter has described a governance-based reporting framework to be used for the analysis of six private finance road projects and one public project. The most striking point to emerge is the lack of financial data routinely made available to the public about privately financed projects, in contrast to the publicly financed bridge.

While the *Freedom of Information Act 2000* and the *Audit Commission Act 1998* and its regional equivalents might have been expected to make such information available, the legislation and the way it is interpreted by the public agencies enable them to withhold information from the public, which could reasonably have been expected to be released, on the grounds of 'commercial sensitivity' and cost. Furthermore, although the Act has undoubtedly led to the release of more information, and some of this may now be routinely reported, there does not appear to be any central guidance to public authorities about the disclosure, format and location of their financial information in general and PPP information in particular that would enable the public to access it more easily across all public authorities.

With different financial objectives from the traditional public sector, the corporations owe accountability to their shareholders, not their users, taxpayers or the public at large. They are excluded from the operation of *Freedom of Information Act 2000* both directly and indirectly, despite their *de facto* role as public authorities. By contrast, the public agency managing the publicly procured bridge routinely published financial and operational information and provided almost all the old information required.

Taken together, this means that as yet, access to information about the decision-making process and the operation and termination of PPP projects is very limited. By contrast, there is full annual disclosure on a routine basis of the publicly procured and managed Forth Bridge. To the extent that little information is available about its procurement, this is likely to be because it was so long ago.

# 7 THE CASE STUDIES

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## Introduction

The purpose of this chapter is to analyse the disclosure and reporting of several UK road projects. Firstly, it discusses the information obtained for the six PPP projects and the Forth Bridge for each of the six phases of the PPP lifecycle in turn. Secondly, it examines the annual cost of private finance for the ongoing projects and the total cost of private finance for the two completed projects, and compares this against the cost of public finance and the cost of the publicly procured bridge. Finally, it presents a summary of the main issues.

## Strategic business case

In practice, it was possible to obtain only one strategic business case (A74(M)/M74), on which the NAO also reported (1999c). In one further case, the Skye Bridge, the National Audit Office had carried out a VFM investigation shortly after financial close (NAO, 1997). The failure to release the strategic case for private projects contrasts with what has hitherto been the normal case for publicly procured roads.

In the two cases for which some information is available, it is far from clear that a sound strategic case had in fact been made. Indeed, the NAO (1998) made the point that the first projects chosen for DBFO had been languishing on the shelf due to lack of finance and were not necessarily the highest priority. In relation to the A74(M)/M74, the NAO (1999c) questioned the case for the immediate widening of part of the road. In relation to the Skye Bridge where traffic volumes are very low, the case rested upon the poor service provided by the ferry. The Scottish Office did not consider whether a new boat with better equipment would have

provided better VFM. In the event, a new and better ferry service did go into service a year before the Bridge opened.

In the case of the M6 Toll Road, the report of the public inquiry, held in 1995 as a result of local opposition to the road, was never published, despite challenges by the environmental group, Friends of the Earth, raising questions as to whether the specific route was indeed the most appropriate one. Thus, in this and a further two of the DBFO projects, it is impossible for the public to ascertain independently or even know whether a sound strategic case has been made.

As two of the projects, the Forth Bridge and Dartford Crossings, are now more than 40 and 20 years old respectively, it is unclear whether the strategic business cases were retained. However, in both cases, the high traffic volumes, which have exceeded expectations, lead to a presumption that economic need was likely to have been demonstrated.

## **Competitive process**

While the size of the contracts meant that under EU procurement rules, the projects would have been subject to competitive bidding, in practice it is impossible to find out much about the selection process since the information is fragmented and derived from multiple sources unless the NAO has carried out a VFM investigation.

In the case of the Skye Bridge, the NAO (1997) and the PAC (1998) were very critical of the selection process for both the bidders and advisors. The PAC had queried whether the selection of the advisors amounted to ‘jobs for the boys’ (PAC, 1998, para. 33). As well as the probity issue, this served to limit the degree of competitive tension required to deliver VFM. However, in its investigation of a later project, the A74(M)/M74 DBFO, the NAO reported that the selection process had been carried out well (1999c).

In a further case, the Minister of Transport announced that Macquarie Infrastructure Group (MIG), the sole owner of the M6 Toll

Road concession, would finance a link to its underutilised Toll Road. Access to both the strategic case and the contract for the new road was however denied under the *Freedom of Information Act 2000* for reasons of commercial confidentiality. However, the Highways Agency did confirm in a telephone conversation what was implicit in the announcement: that the project had been agreed without either advertisement or competition. Instead, the contract arose from an unsolicited proposal, based upon the refinancing gains by MIG, before the road had even been designed or won planning approval. According to the Highways Agency, this was only a contract to finance the construction and maintenance and not a contract to build the road. Notwithstanding the fact that the road would be built without charge to the public purse and it was unclear that any procurement rule has been broken, this meant that the new road had jumped the capital prioritisation queue as a result of an unsolicited proposal. In other words, instead of the Highways Agency using its share of the refinancing gains for other projects, further initiatives have been taken to make a private road viable that may not have been justified on broader economic grounds.

## Financial appraisal

Financial appraisal entails the comparison of the two options, the PPP and public procurement, the PSC. While the financial appraisal – and its supporting documentation – was used to justify the decision to use private finance in preference to public finance, it was of limited value, as the NAO (2000a) has acknowledged. It was nevertheless the only documentation that set out the anticipated financial costs of the two options at financial close.

In only two cases, the A55 and A13 DBFOs, was it possible to obtain the PSC. In the case of the A13, the Highways Agency claimed that there was no PSC as this was not required. It was only after referring to a higher official, that it was confirmed that it had been prepared. But

the two public authorities – the Highways Agency that had negotiated the contract and TfL that managed the contract – then claimed that the other had the relevant documentation. In all, it took more than a year of correspondence to obtain the document.

In the case of the Dartford Crossings, a parliamentary question revealed that a PSC had not been prepared because it was not required at that time. However, it was impossible to understand from the Highways Agency's answer to a FoI request for the PSC that this was the case. In the case of the Skye Bridge, the NAO explained that no PSC had been developed for the Skye Bridge, because there was at that time no requirement to do so since no public finance was available. The rules on this changed after 1993. There was of course no PSC for the Forth Bridge since this was publicly funded.

It seems likely, given that no PSC was required for the Dartford Crossings, that a PSC was not required for the M6 Toll Road, although the Highways Agency simply refused a FoI request for it, without explaining its decision. According to a press release from Friends of the Earth (02/07/1998), a leaked report from the DoT evaluating the main bids in 1990 revealed that the bid from Midland Expressway Ltd (MEL) which went on to win the concession was 'seriously deficient in many respects'. The report said that the traffic modelling was 'unacceptably crude'; the market research techniques were 'inappropriate' and based upon 'implausible behaviours by drivers'; the revenue calculations were 'optimistic'; and concluded that 'for these reasons we can have no confidence in the forecasts produced by MEL'.

Two of the case studies, the Skye Bridge and the A74(M)/M74, were the subject of *ad hoc* NAO investigations of the decision-making process carried out as part of its remit to consider the VFM, defined in the 1983 Act as economy, efficiency and effectiveness, of public expenditure (NAO 1997; 1999c). The NAO's role, or at least its interpretation of its role, is to lay before the PAC the facts and evidence which the PAC may wish to investigate further and from which the PAC can make an

assessment. The NAO's reports were vital in bringing out the background to the projects, information about the competitive process, the financial case for private finance and some of the contractual arrangements - information that would not otherwise be in the public domain. Each is considered in turn.

### **Skye Bridge report**

The NAO's critical investigation (1997) two years after financial close of the Skye Bridge project as the first private finance deal, was in part at least the product of the controversy over the high cost of the tolls that had attracted widespread media attention. As such, it provided both an *ad hoc* scrutiny of the deal and a response to public concern. It provided much useful information about the decision-making process which would not otherwise have been available. But the report itself was not without limitations. Its financial analysis was far from clear, consistent or complete.

While the NAO made a number of criticisms of the decision-making process, it did not explore them in any detail, simply making the general point that the Skye Bridge project was an early example of a private finance project, implying lack of experience. For example, the NAO noted that the Scottish Office was unable to transfer as much risk, its stated objective, as it had intended to Skye Bridge Ltd (SBL). It did not draw attention to the fact that the Scottish Office transferred risk not to SBL but to the road users. Firstly, SBL's financial risk was reduced by increasing the concession period to 27 years instead of the intended maximum of 20 years, thereby enabling SBL to recover their estimated costs. Secondly, under a 'safety net' provision, SBL would be able to raise tolls by 30 per cent above the rate of inflation if toll revenues fell below a sum corresponding to 1990 traffic levels, implying a toll charge higher than ferry fares in 1991. Yet the Scottish Office's stated objective was that charges should be no higher than the ferry charges.

The Scottish Office thereby ensured that SBL's revenue risk was low, with the risk falling on the road users. Indeed, the NAO admitted as much when it reported on p23, that both the Scottish Office and the company believed that the concession was likely to end within 14 to 17 years. More importantly, these revenue protection measures constituted a form of guarantee by the government, despite its original objective of no disguised government guarantees (DoT, 1989, Section 3), about which the NAO said nothing.

Neither did the NAO draw attention to the low financial risk carried by the private sector partners which provided very little equity capital (£0.5m) and then only at the lenders' insistence, nor to the correspondingly high projected rate of return for the shareholders. On the basis of forecasts of inflation made in 1991, interest rates and traffic, SBL would earn a real rate of return of 18.4% on their capital. The NAO simply cited Price Waterhouse's view that the overall financing structure and terms obtained 'appeared reasonable' and that there was 'little to benchmark' against the rate of return, without any further analysis or comparison of rates of return in other projects with low demand risk.

There were further concerns. Firstly, the NAO uncritically accepted the private sector's financial model, and the lack of an independent model by the Scottish Office. Furthermore, as well as discounting the cash flows, the NAO also converted them to 1991 prices, a methodology that implied double counting, and was not used in the case of the Dartford Crossing or the second Severn Crossing and was likely to generate a windfall gain to the concessionaire (Moles and Williams, 1995). Secondly, it calculated the net additional financing cost, over and above public finance (assumed to be 6 per cent real) was £4m discounted, without explaining it or presenting any evidence to support its calculation. Thirdly, it reported in Figure 10 that SBL was expected to pay £2m corporation tax in present value terms, without stating the expected profits, how this figure was arrived at or who calculated it. In the summary, the report stated that the Scottish Office expected that

profits would be £10m in 1991 prices, while in the note to Figure 10, the NAO stated that the discounted net external financing cost in 1991 prices would be £4m, most of which would be the returns to shareholders. This implied, without explicitly saying so, discounted profits of more than £6.3m after a 30% tax take of £2m, a high return on a small equity stake. Fourthly, the report did not deal with the impact of the Bridge on the revenues and profitability of the nationally owned ferry company. It simply noted that the subsidy for the loss of the route rose by £1m for the following year, without considering subsequent years. These issues were important because they in turn determined the toll charge, the concession period, as well as the net cost to the public sector, albeit to different arms of the state, and the projected VFM. The report's lack of clarity made it difficult to interpret the financial appraisal.

The report did not mention the broader context in which its investigation took place, namely the opposition to the high level of charges, the refusal to pay the tolls, and political initiatives to secure their reduction or abolition (Monbiot, 2000). It did not consider the issue of equity and public acceptability of charges, something the 1983 legislation that established the NAO and defined its VFM mission as economy, efficiency and effectiveness, ignores. The NAO simply noted that the toll charges were comparable in real terms with ferry costs, without showing how the ferry charges had increased significantly in the run up to the opening of the bridge. Yet the protest was also likely to have increased the transactions costs of toll collection, if not those of SBL certainly those of local police and magistrates. That is, costs were incurred by public authorities other than the Scottish Office.

Furthermore, consideration was already being given to how the tolls might be reduced or abolished, which would presumably be determined in the light of the termination clauses in the contract and would necessarily impact on VFM. In the light of the broader public concerns, the report could usefully have considered how the contract would deal with such issues.

While the NAO was unable to demonstrate conclusively that the Skye Bridge was likely to deliver VFM, it did nevertheless conclude that the department would gain through the allocation of risk to the private sector. In short, the report was critical of the procurement and appraisal process, but was itself unclear, providing limited scrutiny of public money.

### **The A74(M)/M74 report**

In its report on the contract on the A74(M)/M74 DBFO, the NAO (1999c) examined the PSC and the contractual arrangements, reiterating many of the points made in its earlier report on DBFO roads, such as the additional risk posed by the use of shadow tolls (NAO, 1998). The report showed how the present value of the DBFO option changed through the bidding process and after financial close. It explained how the shadow tolls payable by the then Scottish Office would vary over the life of the project, resembling more closely the variation in the concessionaire's cost profile than was the case in previous DBFO projects.

But it presented very little detailed financial information about the PSC. It did not break down the costs in terms of the cash flows and the cost of risk transfer as it did in later reports on PPP projects. On the key issue of risk transfer, the NAO noted that the use of shadow tolls created a risk that the private sector could not manage and provided an incentive for the contractor, Autolink, to complete construction ahead of schedule, both of which would have increased the cost to the department.

The present value of the DBFO option at the DoT's final assessment was £193m compared with a PSC of £210m, a £17m difference. Financing charges accounted for 16% of the total discounted cost and were higher than under conventional procurement. The NAO's view was that this extra cost should reflect the cost of risk transfer - provided the finance was raised competitively.

The report noted that the additional £10m shadow tolls that were the result of early opening and the possibility that the department had overstated the cost of the public sector comparator by £10m, eliminated the DBFO's £17m margin of superiority. In other words, there was little or no difference between the two. Despite this and its belief that it was 'not realistic to expect a very high degree of precision and accuracy in such forecasts', the NAO's contradictory conclusion was that, while not clearly demonstrating VFM, it was likely to remain VFM. In other words, it drew conclusions that were not justified by the evidence.

## **Contract documentation**

It was possible to obtain the contracts for five of the six privately funded projects. However, some sections notably the termination clauses had been redacted in the contracts that were still live. But the key issue - who foots the bill should the concessionaire go bankrupt - could only be known if the agreement was published in full.

The case of the M6 toll road revealed the degree of government sensitivity surrounding the release of contracts. There was a public inquiry lasting from June 1994 to October 1995, the longest ever public inquiry into a road, when local people opposed the construction of the road. The terms of the contract were kept secret and not even the Inspector at the public inquiry was allowed to see the contract. After the public inquiry, there were legal challenges to force the government to release the contract, wholly or in part, and prove that it had acted legally. In the event, even under the *Freedom of Information Act 2000*, only an abridged version of the agreement has been released: the key clauses on termination and compensation were redacted. Furthermore, as explained earlier, the Highways Agency refused to release the contract with the M6 Toll Road concessionaire for the building of the new link road. This contract had arisen out of an unsolicited proposal for sharing the refinancing gain and had not been subject to competitive tender.

The contract contained no restrictions on the level of tolls that may be levied, although the concessionaire must give the government six months notice of any change. The introductory charge for cars and light vans was £2, rising to £3.50 from June 2005, while that for lorries, coaches and large vans was £10, later reduced to £7. This high charge for large vehicles received adverse publicity in the press which attributed this to the desire to discourage them from using the road, due to the high maintenance costs they impose on roads. In effect, the public road network would have had to continue to bear the cost.

That said, it was in fact very difficult to understand the significance of the contract terms without specialist knowledge and further contextual information.

It was therefore unclear whether the advantages claimed for the policy and outlined in chapter two were translated into enforceable contracts. No executive summaries of the key clauses were provided to help the public understand the financial implications of the agreements. By way of contrast, there was no contract for the publicly provided Forth Bridge, which has been managed by a statutory body, FETA and its predecessor.

## **Annual disclosure**

### **Annual public sector reporting of DBFOs**

The three authorities vary in the degree to which they provide the necessary financial information on a routine, annual basis about their payments. The Scottish Executive reports past and planned expenditure on the A74(M)/M74 DBFO on a cash basis in its annual expenditure report which is part of the annual budgeting process. Its annual consolidated accounts report the payment separately in notes to the accounts. In the case of the Welsh Assembly, such information as exists is aggregated across all its DBFO contracts, both in relation

to its budgets and annual accounts. Thus it is impossible to compare actual and expected payments. TfL, on the other hand, reports expected payments for each DBFO contract, but aggregates actual payments for all its DBFO contracts in its annual accounts. Thus again, it is impossible to compare actual and expected payments.

The three authorities did provide information under the *Freedom of Information Act 2000* about their annual payments, which matched neither the Treasury's database of annual payments nor revenues shown in the private companies' accounts, although the latter may be subject to timing differences.

But in so far as the public authorities do not list the actual payments for each contract in their accounts, it is unclear how individual contracts impact on affordability. By way of example, it should be noted that a Highways Agency official has stated that the annual payments for all its contracts are £300m a year, or 20% of its budget for 8% of its roads. The contract for the M25 will add a further £300m a year, meaning that 40% of the budget will be committed for a very small proportion of the network (Taylor, 2005). While this was revealed to the Stock Market via Standard and Poor's, it has not been possible to find a similar statement on either the DfT or the Highways Agency's web sites.

It is also unclear whether any penalties were ever deducted on the DBFO schemes. Although information about how satisfactorily or otherwise contracts are operating is crucial for assessing the degree to which the contracts incentivise the private partners to deliver the appropriate level of service, this non-financial information is also not disclosed.

In addition, the authorities did not report the cost of monitoring and managing their contracts, which may have been contracted out, although the managers of the A55 and A13 contracts were able to provide such information. But in one of these, the cost varied so much between years that it was difficult to understand without further explanation.

The Scottish Executive, in contrast to the Highways Agency in England, reports the A74M/M74 road is off-balance sheet. Both the A13 and A55 appear to be off-balance sheet since only DBFO revenue payments are reported. In short, all three authorities report the contracts as off-balance sheet and thus conflict with the way that the Highways Agency accounts for its DBFO contracts, which are now all on balance sheet.

The public authorities' management reviews were generally uninformative in relation to their DBFO contracts. None of the authorities reported any contingent liabilities in relation to these contracts, such as any potential legal cases. However, the construction element of the A13 project was late and over budget and the private partner had served notice of its intention to claim against the public authority. TfL did not disclose this in the accounts but did report it in its prospectus for a bond for London Underground. While the claim came to nothing, the point is that this would not have been disclosed at all were it not legally required for the capital markets, and the location of disclosure was not an obvious one for the public.

### **Scrutiny and evaluation of DBFO projects**

With so little information routinely available in the annual report and accounts or elsewhere in the public domain, it is difficult to know how these contracts are operating. The House of Commons Transport Select Committee and similar bodies in the Scottish Executive, Welsh Assembly and the London Assembly and their corresponding watchdogs are charged with scrutinising the authorities' accounts on an annual basis. But the level of aggregation, both of DBFO contracts and agencies within a department or authority, makes this difficult. There is no evidence from the annual scrutiny reports that these contracts have attracted their attention. Furthermore, not only is the annual scrutiny limited, *ad hoc* scrutiny of the operation of the projects appears to be absent.

It is not clear that the authorities themselves carry out any *ex post facto* formative assessment of VFM. If they do, they do not put the results in the public domain. For example, although the Office of Government Commerce (OGC) has instituted a programme of Gateway Reviews to monitor and manage procurement as part of a government reporting and accountability framework, these reports are confidential and subject to exemption from the *Freedom of Information Act 2000* on a number of grounds, including commercial interest. In addition, they do not appear to be applied retrospectively: the case studies were all signed prior to 2000 when the OGC was required to prioritise the implementation of the Gateway process (Cabinet Office, 2000). A request to the Welsh Assembly for information on Gateway reviews in relation to the A55 elicited the following response:

*Transport Wales introduced Gateway reviews in 2006. The A55 Llandegai to Holyhead PFI scheme pre-dates the introduction of the Gateway review process and officials are still considering how this process will apply to this particular PFI contract.<sup>1</sup>*

### **Annual public sector reporting and scrutiny of the freestanding projects**

As the contract for the Dartford Crossings involved no payments, grants or subsidies to the concessionaire, there were no annual financial transactions to report in the DoT's annual report and accounts.

In the case of the Skye Bridge, Treasury guidance at the time was that the scheme would be off-balance sheet. Thus for several years, the Bridge did not figure in the Scottish Office's balance sheet. However in 2003, the project was brought on balance sheet as a result of the Scottish Executive's somewhat late review of the revised Treasury guidance on the treatment of PPP projects.

Although the intention had been that road users would pay the tolls, due to the public uproar over the high cost, the Scottish Office/Executive agreed to subsidise the tolls for frequent users as from January 1998 and freeze the tolls to users from January 2000, at its own expense. It further agreed to pay the VAT charges to avoid toll increases. The VAT is interesting because at financial close it is unclear whether the tolls would be subject to VAT. In the event, the tolls became liable for VAT. According to the NAO (1997), the intended allocation of any changes in the VAT treatment was unclear at tender stage. The fact that the Scottish Executive bore the cost of both VAT and subsequent toll increases illustrates that irrespective of the intended or indeed actual allocation of the risk, risk was in the final analysis a political issue.

The Scottish Executive reported the annual payments to the concessionaire (including past and where appropriate expected payments) in its annual expenditure reports, compiled as part of the budgeting process. It also reported its annual payments in its consolidated resource accounts.

In the case of the M6 toll road, which was to be built without public support of any kind, the Highways Agency's annual report and accounts made two references to the road. Firstly, following standard accounting practice, the Agency included in its tangible fixed assets an amount for the reversionary interest which is being built up during the period of the 54 year concession. Secondly, it reported an outstanding debt payable by the concessionaire at a commercial rate of interest, made up of two elements. The first related to the capital cost of land leased from the Highways Agency by the concessionaire that will build up over the life of the concession and then be treated as a fixed asset when the contract reverts to the state. The second related to the repayment of costs incurred by the Agency of about £5m for land acquisition and compensation. This is due to be repaid in full by 2009. In other words, these accounting treatments recognise the public interest in the value of the land.

The Dartford Crossings, where traffic volumes were high and thus toll charges stable, did not attract public attention. Neither therefore did they lead to any scrutiny.

The case of the M6, where traffic volumes were 50,000 vehicles a day, less than other motorways and less than the 75,000 forecast by the company at the public inquiry ten years earlier, did attract adverse comment. The Highways Agency commissioned reports on traffic volumes and the impact on the non-tolled M6 that showed a 10% reduction in traffic on the M6, but the reports did not compare this against its own or the company's projections, or consider the impact of this on toll revenues or the viability of the project (Highways Agency, 2004; Atkins, 2005). While the concessionaire subsequently reduced the charges for heavy goods vehicles and raised the charge for cars, it was unclear whether this was a political or economic response to the situation.

In the case of the Skye Bridge, the public furore over the toll charges led the Scottish Executive to subsidise the tolls for frequent users, pay the VAT charges, review the tolls, which were compared against tolled estuarial crossings in the UK (Scottish Executive, 2004) and ultimately to terminate the concession. Thus, arguably, the toll review constituted a form of scrutiny. But this was not a review of the deal *per se* and therefore did not investigate why the tolls were so expensive in terms of the structure of the deal.

In short, the public authorities report their transactions in relation to the freestanding projects in accordance with accounting regulations. Oversight of such projects is at best limited. The *ad hoc* nature of such reviews that do take place are the result of public disquiet and do not deal with the structure and operation of the projects but the issue that gives rise to public concern, that is: the symptom not the cause.

## Annual public sector reporting of the Forth Bridge

There are three useful sources of information about this publicly funded project: the Report and Accounts, the Annual Report and the FETA website. Since FETA and its predecessor body provide financial statements for the bridge as a single entity in the Report and Accounts, the level of transparency about the financial costs of and the revenues generated by the project is very good. However, prior to the development of accounting standards, FETA's accounts did not show a depreciation charge.

The revenue account is useful in that it shows budgeted and actual figures for the current year as well as actual figures for the comparative year for both income and expenditure for each budget line. Non-recurring expenditure is shown separately, as is revenue contribution to capital expenditure and interest payments.

The capital account provides information about the initial expenditure, which includes the original cost of the bridge and approach roads, approximately £27m, and detailed information about additional expenditure, which now totals some £60m, and is split between completed and ongoing schemes. It is therefore possible to identify that, for example, £10m has been spent on suspender replacement and £58,000 on toll equipment in the last two years, and if required an interested reader could track back through the years to identify how much had been spent since inception on these and other schemes.

The notes to the accounts do provide information about related party transactions between FETA and the councils that are its members. In recent accounts, these total some £1m.

Information about fixed assets has been provided in different forms over the years. In the early years, capital expenditure, that is, without depreciation, was shown on balance sheet together with capitalised interest, and these amounts continued to increase throughout the 1960s, even after the bridge was opened to the public. Thereafter, capital

expenditure was shown on balance sheet at an amount equal to the debt outstanding on that expenditure, until in the year ending March 1994 the debt was repaid. In recent years a fixed asset is shown on balance sheet with depreciation calculated.

In the private and increasingly in the public sector, governance has focused on the quality of internal controls, and for the first time in the Report and Accounts for the year end March 2003, the financial statements included a 'statement on the system of internal financial control', which in summary suggested that 'reasonable assurance can be placed upon the adequacy and effectiveness of the Board's internal control system' (p.9), but that work in three areas would enhance the control environment: (i) the formal adoption of a fraud policy; (ii) completion of current work on a risk register; and (iii) the introduction of a Local Code of Corporate Governance.

The Annual Report also provides an extensive range of non-financial statistical data relating to traffic volumes and operational issues, and information on internal control. It is made clear that week-day volumes have exceeded the theoretical capacity since 1997, and that currently on average volume exceeds theoretical capacity by 30,000 vehicles per day.

As in the case of the Dartford Crossings, the high traffic volumes have meant that the toll charges have been low and stable. Nevertheless the tolls have been unpopular. There is no evidence that the Forth Bridge attracted external scrutiny, other than in relation to the broader toll review carried out in the context of the public disquiet over the Skye Bridge cited earlier. It seems that it was only when the tolls were used for other purposes that the Forth Bridge became contentious, leading to the Scottish government's decision to terminate the tolls in 2007.

## **Annual private sector reporting of the DBFO and freestanding projects**

Each company's income and expenditure relates to only the one contract and/or the previous year. They disclose the minimum required under company law about both their income and operating costs. With no requirement for symmetry under UK GAAP, the DBFO companies' income may not correspond exactly with the payments by their public sector partner. While this may be due in part to timing differences and VAT on some element of the payments, there are some differences that cannot be explained. They do not report whether their receipts have been subject to any deductions for poor performance or whether they were more or less than expected at financial close.

As a result of their corporate structure, as shell companies with no employees, the reporting of their operating costs is very opaque. This is because they pass the monies received to subcontractors, typically their sister companies. Reporting is very limited because they make full use of the permitted exemptions for related party transactions. It is therefore impossible to understand their subcontractors' costs.

Although the infrastructure assets are reported in a variety of ways, the justifications for the different treatments are not explained. Of the three DBFO companies, two report the assets as tangible fixed assets, whilst the third transferred the value of the assets from tangible fixed assets to financial debtors. The Dartford Crossings assets are reported as tangible short leasehold assets, whilst the M6 toll road is reported as a tangible fixed asset. Skye Bridge is reported as an intangible fixed asset. The M6 Toll road SPV records the capital cost of the land leased from the Highways Agency as a fixed asset and a related creditor, with lease payments payable from 2010 at a 6% rate of interest. Those SPVs that recognise the road or bridge as a tangible fixed asset on their balance sheet, depreciate the asset over the life of the contract.

One DBFO company records a loan from its parent at an interest rate significantly higher than the market rate, thereby providing further evidence as to how the overall profit taken out from a contract can be disguised.

It is noteworthy that two of the companies reported ongoing legal claims as contingent liabilities. This contrasts with TfL that did not mention a legal case relating to the construction of the A13 (in its accounts). None of the companies reported reserves that ring fence monies for future maintenance costs.

Other information does become publicly available, although not in ways that can be systematically captured by the public. This is because the London Stock Exchange requires disclosure of certain types of information, particularly any changes that may affect future profits, the ability to service their bonds, or the failure to meet key milestones that trigger penalties. The credit ratings agencies' surveys may provide such information or the companies may themselves issue press releases. For example, in the context of other DBFO projects, Standard and Poor's (2003) reported that traffic volumes in some cases differed from expectations, thereby affecting revenues, and that there had been few penalty deductions since the contracts were complex and difficult to enforce.

It is believed that in some cases at least the public authority or its parent body monitors the DBFO's annual statements. It is not however apparent that either the authority has been able or that the National Audit Office has used its 'right to roam' to track the costs of the subcontractors. Neither is it clear what steps they take to ensure that their private partners have adequate funds for future road maintenance via the ring fencing of their surplus funds.

## Contract termination

In two cases, the Dartford Crossings and the Skye Bridge, the contracts had terminated, with the first having run its course and the second terminated early as a result of political pressure.

In the case of the Dartford Crossings, the loan was redeemed ahead of schedule, incurring penalties totalling £31m. Given that the total interest payable over the life of the loan, including the redemption fee, was £148m on a loan that at its maximum was £170m, this seems very high. There was however no explanation by either party of who took the decision, why and whether this was indeed appropriate.

In relation to the Skye Bridge, the main political parties decided to buy out the contract with effect from January 1st 2005 from which time the bridge has been toll free. The decision was the result of the review of toll charges (Scottish Executive, 2004). The review noted that although the concession agreement could have been terminated by changing the law, this would have required primary legislation; the concessionaire would have had to be compensated anyway; it would have discouraged others from entering into PPP contracts; and might have attracted criticism since the same outcome could have been achieved by other means, namely negotiation. But how the termination fee of £26.65m was arrived at was not explained in any of the Scottish Executive's documents. Indeed, the figures were excised from the documents released under the *Freedom of Information Act 2000*.

In both cases, it was unclear how or whether the relevant public authorities determined if the bridges had been handed back in a fit condition for their design life. No summative evaluations are known to have been carried out by the public authorities or watchdogs. In the case of the private sector, neither of the concessionaires has produced winding up accounts showing how the surplus had been distributed. This makes it difficult in the case of the Skye Bridge to determine precisely the cost of debt and equity. In the case of the Dartford Crossings,

where the concession was explicitly structured to prohibit the company from receiving any dividends, although the company appears to have some retained profits, it must be assumed that these will ultimately be returned to the DfT.

In the case of the Forth Bridge, the original intention was that the bridge would be tolled until 28th May 1995, essentially coinciding with the repayment of the debt. Although the debt was repaid in 1994, tolling was extended in 1995 to pay for an upgrade and an automatic vehicle detection scheme. Tolling has since been extended three times, with the most recent extension originally due to run until March 2010. The Forth Estuary Transport Authority Order 2002 extended the purposes for which tolls could be used to include not only the operation and maintenance of the bridge but also improvements to local feeder roads, the A8000 spur road and alternative transport systems, as well as for bridge specific improvements. This policy was deeply controversial because of the spiralling estimates of the cost of the A8000 and the lack of clarity about the total cost to be paid by the bridge users. There was also talk that a proposed new bridge across the Firth of Forth might be partially funded from the tolls. However, in 2007, the ruling coalition in the Scottish Assembly announced that it would terminate the tolls and thereby the project.

## **Cost of private finance**

While the business cases used to support the case for private finance estimate the cost of private finance at financial close, it is possible to use the accounts of the SPVs to make some assessment of the actual costs and returns to the providers of finance, and compare these against the cost of public finance, and thus the cost to the public sector of using the private sector as financial intermediaries.

## Ongoing contracts

The annual cost of finance for the four ongoing projects from this research project is analysed and compared against similar information from the Highways Agency's first eight DBFOs in England and the 24 toll road concessions operational in Spain in 2002, with appropriate accounting adjustments for the way that income, capitalised interest and the reversionary fund are reported (Shaoul *et al.*, 2006; Acerete *et al.*, 2009). In each case, the most recent year for which the companies' financial statements were available, when they were in steady state, was used. As such, their financial performance is stable year on year.

Table 7.1 shows that depreciation was a significant element of annual costs for those SPVs that recognise the road as a tangible fixed asset, that is, all except the A74M. For the A55, the depreciation charge was higher than all other operating expenses.

Annual cost of operations and maintenance, excluding depreciation, for all the roads, including the eight earlier DBFOs and the Spanish toll roads, took a relatively small proportion of revenue and were broadly similar at 14% to 27% of revenue (Table 7.1, line 3). That is, in most and particularly the early years, the cost of operations and light maintenance is low, as costly maintenance is relatively infrequent. Operating profit before interest and tax was therefore correspondingly high.

*Table 7.1 Cost structure of current private finance projects*

	A74M DBFO		A55 DBFO		A13 DBFO	
Year ending	June 2004		March 2005		Dec 2005	
	£m	% income		% income	£m	% income
Income	22		14		25	
Depreciation (non-cash)	0	0	3	22%	3	12%
Other operating expenses (cash)	5	23%	2	14%	6	24%
Total expenses	5	23%	5	36%	9	36%
Operating profit before interest and tax	17	77%	9	64%	16	64%

	8 DBFOs in England		M6 Toll Road		Spanish Toll Rds	
Year ending	2004		June 2006		2003	
	£m	% income		% income	€m	% income
Income	176		51		1,428	
Depreciation (non-cash)	24	14%	17	33%	292	21%
Other operating expenses (cash)	48	27%	10	20%	320	22%
Total expenses	72	41%	27	53%	612	43%
Operating profit before interest and tax	104	59%	24	47%	816	57%

Source: Annual report and accounts (various years).

Most of what remained after operating expenditure was attributable to the cost of finance: interest payable and post tax profits. This can be illustrated as follows. There was little tax payable on UK contracts, as shown on the fourth line of Table 7.2, and in more than one case, the annual accounts revealed that no tax would be paid due to deferred tax. It should be noted that the amount of tax payable was considerably less than the 22% tax yield that KPMG (2002) assumed under PFI and was incorporated into the more recent VFM appraisal methodology.

UK financing costs therefore, shown in the final line of Table 7.2, amounted to at least 64% of the revenues from either the public authority or road user. The Highways Agency's DBFOs were particularly high (83% of revenues) reflecting the refinancing gains made during 2004. In previous years, financing costs were at least 60% of revenues. The financing cost of Spanish toll roads, at 55% revenues, was similar to the UK DBFOs.

*Table 7.2 Estimated annual cost of public debt in current private finance projects*

	A74M DBFO		A55 DBFO		A13 DBFO	
Year ending	June 2004		March 2005		Dec 2005	
	£m	% income	£m	% income	£m	% income
Interest payable	13	59%	8	57%	16	64%
Capitalised interest	0	0%	0	0%	0	0%
Total interest	13	59%	8	57%	16	64%
Tax payable	1	5%	0	0%	1	4%
Profit after interest and tax***	3	14%	1	7%	1	4%
Total returns to providers of finance****	16	73%	9	64%	17	68%

	8 DBFOs in England		M6 Toll Road		Spanish Toll Rds	
Year ending	2004		June 2006		2003	
	£m	% income	£m	% income	€m	% income
Interest payable	82	47%	45	88%	168	12%
Capitalised interest	0	0%	0	0%	70	5%
Total interest	82	47%	45	88%	238	17%
Tax payable	8	5%	0	0%	266	19%
Profit after interest and tax***	63*	36%*	-21	-	546	38%
Total returns to providers of finance****	145*	83%*	45**	88%**	784	55%

Source: annual report and accounts (various years).

Notes:

\* Affected by refinancing gains

\*\* Providers of debt finance receive 88% of revenues, while equity stakeholders make a loss. £45m reflects interest only

\*\*\* Post tax profit may not always reconcile with operating profit before interest and tax due to the inclusion of non-operating items

\*\*\*\* Total returns to providers of finance = total interest plus profits after tax

Line 6 of Table 7.3 shows the total annual returns to the providers of finance, that is interest payable and post tax profits, in relation to the total capital employed (shareholders' funds and debt). This varied between 7% and 15.7%, for the DBFO projects, with the most recent schemes, the A55 and A13, having lower financing costs, in part because interest rates had generally declined. The M6, which was in deficit, was paying 5% to service its loans. The Spanish toll roads' total cost of capital was 9% of capital employed.

It was possible to estimate and compare the annual cost of private finance with the cost of public debt for illustrative purposes, making several conservative assumptions. Firstly, a public loan from the Public Works Loan Board (PWL) as opposed to financing out of current government revenues was assumed. Secondly, the size of the loan would be equal to the current level of private sector debt, although this was substantially higher than the cost of construction in four out of the six examples used here, and would also have included the higher transaction costs of such schemes. Thirdly, the loan period would be 20 years since the 30 year length of PFI or DBFO contracts are premised upon 20 year loans with subsequent years to generate a return for the shareholders, particularly since the early years were expected to be unprofitable. Fourthly, the PWL's rate of interest at the time of financial close: 7.75%, 4.75%, 5.6% and 8% for the A74, A55, A13 and 8 Highways Agency roads respectively. In the case of the M6, 4.9% was used, the PWL's rate prevailing at the time when construction started since the contract was signed many years earlier, and a 35 year loan period was assumed since the concession was for 54 years. For the Spanish roads that were built over a period of time in the late 1990s, an average rate of 7% was used. Such rates of interest are the government's cost of borrowing on Treasury gilts (Debt Management Office 2008). These rates of interest are shown in line 7 of Table 7.3 and, apart from the Highways Agency DBFOs whose returns were unusually high that year, are about two percentage points below the total return on capital employed by private sector (line 6 of Table 7.3). Lastly, the same toll charges have been assumed. Line 8 of Table 7.3 shows the estimated annual cost of public debt, which due to the conservative assumptions is likely to be on the high side, apart from the M6 Toll Road.

Table 7.3 *Estimated extra annual cost of private finance in current projects*

	A74M DBFO	A55 DBFO	A13 DBFO	8 DBFOs in England	M6 Toll Road	Spanish Toll Rds
Year ending	June 2004	March 2005	Dec 2005	2004	June 2006	2003
	£m	£m	£m	£m	£m	€m
Construction cost	96	100	229	590	700	2,600
Actual debt	150	110	231	924	828	4,116
Shareholders funds	3	2	2	58	1	4,981
Total capital employed	153	112	233	982	829	9,097
Actual returns to providers of financed (interest and post tax profits)	16	9	17	145	45*	784
Return on total capital employed **	10%	8%	7%	15.7%	5%*	9%
Public sector rate of interest prevailing at financial close	7.75%	4.75%	5.6%	8.0%	4.9%	7.0%
Estimated interest on same level of debt at public sector rate	12	5	13	74	41	288
Extra cost of private finance (line 5 less line 8)	4	4	4	71	4	496
Extra cost of finance as % income from state or users	18%	29%	16%	40%	8%	35%

Source: annual report and accounts.

Notes:

\* interest only

\*\* return on total capital employed + actual returns to providers of finance/total capital employed

The last line of Table 7.3 shows the impact of the estimated additional annual cost of private finance over public debt on the toll revenues. In the case of the three DBFOs that are the focus of this study, the estimated additional cost was at least 16% and in one case as much as 29% of the income received from the state. While there is some variation in the relative proportion of finance to revenue, which may be due in part to the variation in traffic flows, the average is about 20%. That is, out of every pound received from the public authorities, 20 pence is the additional cost of private finance.

The earlier Highways Agency DBFOs had an estimated additional cost of finance equal to 40% of revenues. While some of this was due to refinancing gains, even in earlier years, the additional cost of private finance was about 21% of revenues, the same as the other more recent DBFOs. In the case of the loss making M6 Toll road, the additional cost of private finance was 8% of revenues. In the case of Spain, the estimated additional cost of private finance was 35% of revenue, somewhat higher than in the UK, despite the concessionaires continuing to receive considerable public support.

According to the NAO (NAO, 1998; 1999c), the additional annual cost of private finance is attributable to the cost of risk transferred to and borne by the project companies, the main justification for the policy. Our analysis suggests that this cost calculated *ex post facto* after project implementation on road projects is broadly similar across all the DBFO projects irrespective of the characteristics of the particular project and is about two percentage points (the difference between the effective cost of private capital and the cost of sovereign debt). This represents a charge to the public sector every year of the contract. The NAO (1998, Appendix 6) confirms this, saying that the difference between the public and private cost of capital and hence the risk transfer is approximately 2.5 percentage points.

However, our estimate of the additional cost of private finance was an underestimate since the size of the loan was often considerably higher than the cost of construction and there were leakages in the private sector's supply chain that cannot be quantified: the contractors and

subcontractors' cost of capital, typically subsidiaries of the SPVs' parent companies, information that is not publicly available. Furthermore, while corporation tax payable has been omitted from these calculations, arguably tax should be included since it constitutes an additional cost to the procuring authority, although not the Treasury. Under conventional procurement or public debt, the public authorities would not be liable for tax. Thus, the estimate of the additional annual cost of private over public finance was a very conservative one.

Several points flow from this analysis. Firstly, the additional cost of private finance is broadly similar across several projects, irrespective of their characteristics. Secondly, while there are circumstances that are specific to Spain, as noted earlier in chapter three, the point is that the additional cost of private finance is a universal not UK-specific phenomenon. Thirdly, if the state had financed the roads, tolls – if charged – would have been considerably lower in each case. Fourthly, while this additional cost is attributed *ex ante* to risk transfer, it is unclear what risks, other than demand risk, are in practice borne by the private sector since the DBFOs were selected from projects that had already been designed and gone through the planning stage, thereby reducing some of the key risks (NAO, 1998; Shaoul *et al.*, 2007b).

While determining *ex post* whether the higher cost of private finance constitutes VFM is a matter of judgement, the NAO does provide a yardstick in relation to post-tax profits on PFI projects. It cites the government's Office of Government Commerce (OGC) for 'normal' post-tax rates of return on PFI projects as being 8-15% (PAC 2003, figure 2). The return on shareholders' funds for the DBFOs was 100%, 50%, 50% and 109% for the A74M, A55, A13 and Highways Agency's DBFOs respectively. While the Highways Agency's returns were unusually high in 2004, returns in the years 2000 to 2003 were, with one exception, higher than the 'normal' rate anticipated by the OGC. Furthermore, if the loans are indeed repaid within 20 years as the policy's developers expected, then this means that the returns to the shareholders will be even higher in the last years of DBFO contracts.

It seems logical to assume that the additional cost of using the private sector as a financial intermediary will affect the public authorities' budget. For example, under conditions where the Highways Agency spends £300m a year on its 14 DBFO schemes, a sum equal to 20% of its budget, for just 8% of its network (Taylor 2005), then this represents a significant additional cost for the public authorities and must come at the expense of investment and maintenance elsewhere. But how this impacts on the rest of the budget is unknown.

Finally, and most importantly from the perspective of this study, the cost was sufficiently large to warrant greater transparency. As it stands, the lack of information about the original bids, expected and actual traffic flows, level of performance, penalty deductions, the cost of operating and maintaining the roads and any contract changes means that it is not possible to understand whether the additional cost of private finance is justified. But the fact that the additional cost of private finance is high across a number of projects raises questions about whether the appraisal methodology and process for assessing VFM is appropriate.

### **Completed contracts**

The Dartford Crossings and the Skye Bridge, both of which have now terminated, presented an unusual opportunity to examine the total cost of private finance. In each case, the nominal values as shown in their accounts were used.

#### *The Dartford Crossings*

Line 3 of Table 7.4 shows that the cost of operating and maintaining the Dartford Crossings, excluding the depreciation charge, was 46%, much higher than the DBFO projects due to the costs of tolling, and operating and maintaining the bridge and tunnels, which would be higher than for roads. Line 9 shows that financing costs, which include most of the debt of one of the pre-existing tunnels, are relatively low at 20% of total revenue.

Table 7.4 Cost of private finance in completed projects

	Dartford		Skye	
	£m	% revenue	£m	% revenue
Total number of years of contract (actual) including construction	16	16	13	13
Total revenue	740		73**	
Total depreciation	196	26%	16	22%
Total other operating costs	343	46%	8	11%
Total operating costs	539	73%	24	33%
Total operating profit before interest and tax	201	27%	30	41%
Total tax payable	52	7%	3	4%
Total net interest payable	148	20%	20	27%
Total post tax profits	2	0%	7	10%
Total financing costs	148*	20%	27	37%

Source: annual report and accounts.

Notes:

- \* As Dartford Crossing Ltd does not keep the post tax profits, this is not included in the finance total.
- \*\* This includes: turnover, deferred income and termination fee

While no comparisons were made at financial close of the comparative costs of public and private finance, it is possible to do so on an *ex post facto* basis, assuming on a conservative basis: (i) a public loan, as opposed to financing out of current government revenues; (ii) a loan taken out at the beginning of the period for £170m, an amount equal to the maximum loan taken out by the private sector that was higher than the cost of construction, varied considerably during the contract, and would have included the higher transaction costs of such schemes; (iii) an

8.78% rate of interest, the PWLB's interest rate at financial close; (iv) a loan period of 13 years, as this was the actual period of the loan; and (v) tolls. As lines 4 and 5 of Table 7.5 show, annual payments on public debt including interest and repayment of the principal would be about £21m and total payments £268m. This is much lower than the £148m interest and loan repayment of £170m, on lines 6 and 3 respectively, which total £318m, as shown on line 8. While such conservative assumptions can clearly be varied and it is unclear what the most appropriate assumptions are, this means that the additional cost of private finance is about £50m or 7% of total revenues, as shown on line 9.

*Table 7.5 Total additional cost of private finance in completed projects*

	Dartford		Skye	
	(£m nominal)	% revenue	(£m nominal)	% revenue
Total number of years of loan	13	13	13	13
Total revenue	740		73	
Public loan (=private sector's maximum)	170	-	24	-
Estimated annual payment (interest + principal) on public loan	21	-	2.56	-
Estimated total payments (interest + loan) over period on public loan	268*	36%	33**	45%
Private sector's interest	148	20%	20	27%
Private sector's equity returns (post tax profits)	0***		7	
Private sector's total cost of capital + debt****	318	43%	51	70%
Extra cost of private finance	50	7%	18	25%

Source: annual report and accounts (various years).

## Notes:

- \* 13 years at 8.75%
- \*\* 13 years at 6%
- \*\*\* As Dartford Crossing Ltd does not keep the post tax profits, this is not included in the finance total.
- \*\*\*\* Total finance costs (interest plus post tax profits) plus loan repayment

This is lower than the additional cost of private finance relative to income for the DBFOs as the result of several factors. Firstly, it will be recalled that the revenues included the two tunnels as well as the bridge, all three of which had traffic volumes far in excess of that originally forecast. In essence, it received revenues from three crossings while financing just two and maintaining three. Secondly, the concession was explicitly structured to prohibit the company from receiving any dividends. In other words, there were no returns to equity. Thirdly, the actual cost of capital was an underestimate since the corporate structure entailed subcontracting operations and maintenance and thus the possibility of transfer pricing to its sister companies. Furthermore, the shareholders derived a fee income from the project and some of the share holders or their sister companies provided the loans. Finally, this excluded taxation, a cost that the users have paid via the tolls.

### *The Skye Bridge*

In the case of the Skye Bridge, line 4 of Table 7.4 shows that operating costs, excluding depreciation, were 11% of income, while line 10 shows that financing took 37% of income.

Again, the additional cost of private finance can be calculated and compared against an estimated cost of public debt. Assuming a £24m loan taken out at the beginning of the period for 13 years at a 6% rate of interest (see NAO 1997, para 4.7) and that the road would be tolled, then the annual payments would be £2.56m and the total payments over the period would be £33m as shown in Table 7.5 on lines 4 and

5 respectively. The additional cost of private finance is therefore about £18m or 25% of revenues, as shown on line 9.

This is higher than the cost of the Dartford Crossings whilst less than the DBFOs. However, this downplays the additional costs of using the private sector to finance and operate the bridge. Firstly, it was an underestimate since it leaves out any gains made via subcontracting to sister companies and the cost of corporation tax, costs that would not have been borne or at least not to the same degree under conventional procurement. Secondly, the NAO (1997) acknowledged that the construction costs were about £20m, less than the value of the loan. Thirdly, under public finance the large transaction costs and most of the projected operating costs of £4m in discounted 1991 prices would have been avoided since the bridge would have been free. Fourthly, this was a small scheme, which as the government has now acknowledged (Treasury, 2003) was not suitable for a PPP. Fifthly, and even more importantly from the perspective of this analysis, the £24m loan represented only part of the total cost of the bridge: the government contributed £15m towards the cost of the approach roads (Moles and Williams, 1995; NAO, 1997). Finally, the contract's revenue protection measures constituted a form of government guarantee that served to reduce the concessionaire's financing costs (NAO, 1997).

As explained earlier, the problem with this scheme was the low traffic volumes, and correspondingly high tolls, that could never have generated sufficient revenues to make this a commercially viable project without government support. As the Dartford Crossings show, the key was high volumes relative to construction and financing costs. While the Dartford project included three crossings that can be justified from a traffic management and operational perspective, it is clear that to make new road schemes viable may entail bundling the new construction work with existing high volume roads.

While with toll schemes it is the road users not the taxpayers who pay, private finance for public goods with wider external benefits and problems creates an additional cost. In the case of the Skye Bridge,

those costs were so high that the Scottish Executive had to step in with taxpayers' money: £34m for subsidies, VAT and the termination fee, costs that the road users would otherwise have borne. This was higher than the construction cost of the bridge which the then government had said it could not afford. Thus, where traffic flows are low relative to the construction cost, the users – and/or the company – are unable to bear the cost and the costs ultimately fall back on the taxpayer, as the international experience cited in chapter one demonstrates.

By way of comparison, over the original 30 year life of the Forth Road Bridge total revenues collected between 1965 and 1994 were approximately £96m and interest charges were £27m, 28% of revenues. This is slightly less than the estimated annual interest charges for the DBFOs assuming public debt, probably because the public authority would borrow less. Turning next to the total cost of debt and interest over the original 30 year loan, this was approximately £49m, that is, 51% of revenue. As midway between both the Dartford Crossings and the Skye Bridge, this appears to contradict the notion that the public sector has a lower cost of finance. However, it is difficult to compare the cost of finance between private and public funding in this way because the public authority sets the revenues, the denominator, to recover its costs which are lower under conventional procurement. In other words, the apparent higher cost of finance is a statistical artefact of the level of revenues, the key determinant of which is the volume of traffic.

## Summary

This chapter has examined the content of the information that is published or was provided and found that current reporting practices do not provide adequate information for the public to understand the basis of the decision to use private finance and how it operates in practice. This contrasts with the publicly financed Forth Bridge where disclosure was generally very good.

This study has found that little if any information is disclosed about the decision-making process, unless there has been an investigation by the

appropriate public watchdog. Such information that is available does not provide assurance that the economic or business need was demonstrated satisfactorily or that competitive pressure was always present, limiting VFM and raising concerns about probity.

The failure to disclose the key clauses of the contract that determine the public's liability in case of project failure is particularly worrying. Furthermore, it is a matter of some concern that the M6 concessionaire is, in the context of the new road to be built linking the M54 with the Toll Road, able to determine road building policy shielded from public scrutiny and visibility.

In the context of the case for private finance, the NAO's evidence from its reports on the Skye Bridge and the A74M/M74, if not its conclusions that the projects were *likely* to deliver VFM, was important because it showed that the government was unable to demonstrate that these DBFO schemes had lower whole-life costs than conventional procurement, illustrating the need for independent external scrutiny of such deals.

In relation to the annual reporting cycle, the financial reporting of both DBFO and free standing projects is very limited due to issues of materiality, aggregation and regulation. The treatment of the asset is inconsistent across public authorities for reasons that are not explained.

*Ex post* scrutiny by both the public authorities and the watchdogs appears to be absent. But there is a further point. The level of *ad hoc* scrutiny in part at least appears to be a function of public disquiet. It was noticeable that the most information was obtained for the Skye Bridge. This was because the level of popular opposition provided the impetus for the NAO investigation, press articles, a BBC investigation, and the Scottish Executive's subsidies, review and early termination of the project. In the absence of any broader popular movement, it is difficult for the public, despite the legislation, to find out much about these contracts.

The reporting by the companies is generally limited and opaque as a result of their corporate structure. To the extent that they provide

additional information over and above that required by statute and the accounting regulations, this is the result of Stock Market rules and is not easy to capture systematically. There is no evidence of any scrutiny of their or their subcontractors' costs, the relations and transactions with their sister companies or the adequacy of their reserves for future maintenance, by the public watchdogs despite the fact that they have the power to do so and the companies are *de facto* public authorities.

In the case of the Dartford and Skye Bridges, the reporting of contract termination by both parties is opaque and incomplete in relation to financial and non-financial information. There does not appear to have been any summative evaluation of the cost of private finance and how such contracts have worked out in practice to inform future policy and practice.

This analysis has shown that the additional cost of private finance is a significant cost. As such, it warrants greater disclosure, scrutiny and a summative *ex post* evaluation of the merit of using private finance to replace public finance. In the absence of any reporting of contract performance or a greater disclosure of costs by both the public sector and its private sector, which operates as a *de facto* public authority, it is unclear whether the rewards are commensurate with the risks.

#### ENDNOTES

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- 1 *Freedom of Information Act 2000* response from Transport Wales, Welsh Assembly government.
- 2 Financial statements for the years 1970–1976 could not be obtained so the revenue and interest costs have been extrapolated for this period.

# 8 DISCUSSION AND CONCLUSIONS

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## Introduction

This chapter draws together important issues raised in the literature and the findings from the cases studies of six privately financed and one publicly financed road projects and relates them back to the questions originally posed in chapter one:

- the additional problems created by the policy; the role played by the European Union (EU) in the regulation, development and reporting of Public Private Partnerships (PPPs);
- the reporting and disclosure required by all the parties involved in PPPs to ensure accountability; and
- the degree to which the current financial reporting framework and practices provide the necessary information for the public.

In interpreting these findings, the themes from the literature review in chapters two to five are utilised. Although each question is considered in turn, there is in fact a considerable degree of overlap. A final section provides a summary and policy recommendations.

## **What additional problems does the PPP policy create?**

PPPs are one form of the hollowing out of the state that has placed many significant decisions and operations beyond the direct control of ministers and departments. Overall responsibility for

regulating and delivering services is held at various levels of central or local government with private sector partners responsible for their provision, thereby blurring responsibility for and control of public services and expenditure. Since reporting and disclosure are critical to holding policy and operational decision-makers to account, the nature of such reporting and disclosure, their regulation and practice, and the availability of information that enables informed representatives of the public to understand the cost, performance and sustainability of PPP projects are key issues.

Although private sector involvement in the construction of public infrastructure and the delivery of public services is not new, PPPs introduce new features. They create new organisational structures and new responsibilities for the public sector to manage over a long period under conditions where needs and the partners, including the subcontractors, may change. These in turn generate new accounting and horizontal governance streams as private sector companies must be held to account for public expenditure under their control. There is some evidence to suggest that the public authorities have not always been able to obtain the levels of service they believed that their private partners were contracted to provide. But the complex and opaque organisational structures in both sectors and the veil of secrecy that surrounds the operation of such contracts mean that reporting, control and accountability lines may be unclear, providing little *ex post* assurance of value for money (VFM) or even sustainability.

The introduction of outsourcing and PPP contracts creates financial reporting problems for the public sector because expenditure that crosses the public private divide now needs to be explicitly disclosed. While new codes of governance for the public sector specify reporting to provide upwards accountability to the executive and Parliament, there has been little attention paid to accountability to users and the broader public or any consideration given to how the private service providers can be made

accountable to the public authorities and thus the public, something that the Liaison Committee recommends should be remedied (2008).

There are no reporting requirements in relation to the decision-making process, either contemporaneously or *ex post*. The private sector reporting framework, which provides the main vehicle for annual financial disclosure and is used by both parties, seeks to assure the providers of finance about the return on their investment. Consequently, it does not require the reporting of non-financial information relating to contractual performance. The use of a generic framework that has not been adapted to cope with policy innovations means that it does not require the disclosure of financial information by all the relevant parties that would be useful in the context of PPPs and reporting to the public.

*FRS 5 Application Note F* and *IFRIC 12* are inadequate in that, although they require a judgement to be made on the issue of risk, the so called on or off-balance sheet treatment, they do not require an explanation as to how that judgement was made. This matters because this decision may be finely balanced leading to different interpretations by each party to the transaction.

Furthermore, there may be various forms of implicit support. The Spanish experience illustrates that PPPs create risk for the public sector and/or may involve extensive public support and implicit guarantees. While governments are potentially powerful negotiators, the NAO has pointed out in the context of UK PPPs that political risk cannot be transferred to private partners. As the collapse of various PPPs and their bailout by government shows, the nature of the infrastructure is usually too important to be allowed to fail. However, the consequent risks and costs are not straightforward to quantify *ex ante*.

The way PPPs are accounted for as either service contracts or leases affects the way that public sector debt and investment are reported in national statistics. Firstly, since most PPPs have been reported as service contracts, their associated debt is treated as private sector debt. While the

adoption of international reporting standards means that PPP debt will in future be reported as public sector debt, this is unlikely to be reflected in national statistics for two more years. Furthermore, Eurostat's ruling on reporting of the underlying asset may perpetuate the ambiguities and inconsistencies. It is therefore unclear whether all PPP debt will come on balance sheet as the International Accounting Standards Board (IASB) intends. Secondly, the combination of leasing and multiple purchasing authorities has meant that the recording of debt and investment as public or private has been a technically demanding task for the Office for National Statistics (ONS). Thirdly, the ONS cannot identify and record any contingent liabilities arising out of PPPs since the public authorities have not classified any implicit subventions and risks as likely to occur. These problems in reporting PPPs mean that it is impossible to obtain an accurate picture of public debt and expenditure and hence understand the degree to which such expenditure is sustainable.

In short, the problems surrounding PPPs take several forms. Firstly, the context in which PPPs operate and the operation of the policy differ from that set out formally in the law, regulations, concessions, licences and government budgets, with the result that the real distribution of risk and costs may fall more on taxpayers and users and less on the financiers than the apparent distribution would suggest. Secondly, PPPs remove public expenditure from the direct control of the public sector and establish contractual relations over very long periods of time that have the effect of committing future governments and taxpayers to expenditures that impact on the budget and hence other public services. Thirdly, the institutional arrangements for the financial reporting of PPPs do not provide disclosure that is useful for the public. Accounting for income streams, assets, liabilities and any contingent liabilities is more complex and controversial than accounting for traditionally procured infrastructure and services. Public sector accounting has now become embroiled in issues that have long been problematic in the private sector and these complexities further limit the usefulness of the private sector reporting framework.

## What is the European Union's role in PPPs?

The EU has changed from a neutral political stance towards PPPs to one proactively supportive of it. However, it plays a limited direct role in PPP policy or individual projects. As such, PPPs are not an example of joined up government, but essentially an issue for each member state. There is therefore a wide variation in the use of the policy in member states and its forms in the road sector are both diverse and proliferating.

This inevitably gives rise to tensions between the political, technical and commercial interests which makes it difficult to reach agreement on an overarching policy for PPPs. Indeed, the failure to formulate such a policy is attributed to the fact that ambiguity favours and is encouraged by the transnational corporations and international financiers.

The EU's role is nevertheless important for a number of reasons. It has sought to open up the public sector to the market as part of its wider liberalisation agenda. Thus its rules on procurement and competition impact on the way that projects are designed, advertised and negotiated. More recently, it has introduced competitive dialogue as a way of resolving some of the problems encountered in negotiating complex projects.

The EU also has a role in approving the accounting regulations under which PPPs are reported, both at unit level and at national statistics level. While listed EU holding companies report under International Financial Reporting Standards (IFRSs), the EU formally approves each IFRS before implementation and reserves the right to make amendments, as in the case of International Accounting Standard 39. Currently international guidance on accounting for PPP type arrangements is being developed.

In terms of national accounting, Eurostat has provided guidance for reporting PPP assets in the *European System of Accounts*. Since the EU is broadly in favour of PPPs, there are institutional pressures to facilitate

this method of procurement by adopting accounting treatments that encourage the policy. This may mean that at least some PPPs count as private sector debt and investment and therefore conflicts with the IASB's position that seeks to bring all PPPs on to the public sector's balance sheet and thus count towards public debt and investment.

### **What reporting and disclosure is needed for public accountability?**

This study identified three inter-related information flows. The first and traditional one is the upward flow from the public authority via the department to government and Parliament. Such reporting and disclosure focus on responsibility for decisions made, probity in the use of funds for the purposes intended by Parliament, and stewardship of the public's assets and resources, as reflected in notions of VFM. The second and newer flow, the downward flow of information to the public, which is the subject of this study, has become increasingly important as a legitimising rhetoric of public service reform. While it is in many ways similar to the upward flow and includes external scrutiny by Parliament, it is also wider, embracing non-financial information about access to services and service performance and also notions of transparency and equity in resource allocation. The newer policy instruments for public service reform and modernisation, PPPs, which follow on from the outsourcing of service delivery, give rise to the need for a third and horizontal flow, from the private sector - acting as a *de facto* public authority - to the procuring authority. This encompasses both financial and non-financial information without which both upward and downward accountability has little substantive meaning.

In the context of PPPs, the public needs to be able to understand:

- (i) the basis for and nature of the procurement decision;
- (ii) the costs of contracts;

- (iii) the values of any reported assets and liabilities, including contingent liabilities;
- (iv) any public subventions;
- (v) the financial viability of both the projects and their operators; and
- (vi) the termination arrangements for completed projects. This entails full disclosure by all parties to the transaction on these six stages: the strategic business case, the procurement process, the financial case, contract, operation and termination.

Accountability to the public therefore implies different forms of reporting and disclosure over and above the private sector oriented financial statements. It also necessitates public access, which implies that such information is straightforward to locate and understand, at least for those with some financial expertise. It entails financial information on a per project basis over the six stages of the project so that assessments about the cost and sustainability of expenditure on individual PPP projects can be made over the various stages of their life cycle. Accountability also entails the provision of non-financial performance measures so that it is possible to understand the degree to which the anticipated benefits are being achieved. In short, information is needed that enables judgements not only about VFM, both *ex ante* and *ex post*, but also about the impact of large projects on budgets in terms of present and future affordability. These considerations formed the basis for analysing the reporting practices of the various parties to three road Design Build Finance Operate projects (DBFOs), three freestanding and, for comparison purposes, one public sector project.

## To what extent does current reporting of PPP projects provide public accountability?

This study has examined the degree to which the reporting and transparency of PPPs provide accurate, transparent and credible accounts that allow the public to judge the scope, direction and sustainability of public spending and investments (Treasury, 2003). A number of points flow from this analysis, each of which is considered in turn.

### Public access to information

This study has shown that there is a lack of clear, consistent and complete information, designed for use by the public and provided on a routine basis by all levels of both the public and the private sector. While the Treasury's database (Treasury, 2006a) provides some information, which may be supplemented by the public authorities and information intended for the capital markets, this is incomplete and inaccurate. As such, these findings confirm an earlier study of Private Finance Initiative (PFI) hospital contracts, which found that information about costs was not disclosed unless there was a specific regulation requiring it (Hodges and Mellett, 1999). Such findings also replicate other research findings about the lack of openness and transparency during the operational phase of PFI/DBFO deals (Edwards *et al.*, 2004; Hood *et al.* 2006).

Even the House of Commons and its Select Committees do not have the same rights as the NAO to see information in relation to PPP contracts in the context of scrutinising public expenditure due to commercial confidentiality, as the Liaison Committee (2008) noted. This must limit their ability to scrutinise such contracts.

Not only is the routine reporting inadequate, the right to additional information via the *Freedom of Information Act 2000* and the *Audit Commission Act 1998* and its regional counterparts is very limited. While the *Freedom of Information Act 2000* is supposed to enable the

public to access information, the grounds for refusing requests – cost and commercial sensitivity - provide ample scope for the authorities, if they so wish, to refuse to provide it. At the very least, it requires some persistence on the part of the research team to obtain the information required from some authorities. The Welsh Assembly and Scottish Executive were more helpful and provided better responses than Transport for London (TfL), the Highways Agency and the Department for Transport (DfT). The different responses by the various authorities suggest that such responses are determined in an arbitrary and *ad hoc* manner.

It was the intention of the *Freedom of Information Act 2000* that not only would information be released in response to requests, but also that the amount and presentation of information routinely provided would improve as a result of the requests received. Thus, a co-ordinated response would result in fewer Freedom of Information (FoI) requests over time. However, while some learning may have occurred, it is unclear that the *Freedom of Information Act 2000* has affected the release of information relating to PPPs on a government wide basis.

Public access is not only about provision of information, it is also about the ease with which information can be found. For example, the accessibility of financial information does not appear to have been fully thought through. While in the private sector, financial statements are usually readily accessible via the company's web site in a location entitled 'investor relations', financial statements may be very difficult to locate in the public sector where there is no similar standardisation. Curiously, TfL's financial statements are located under investor relations.

By far the most information was obtained from the Scottish Executive for the Skye Bridge. This was because the level of popular opposition provided the impetus for press articles, the NAO investigation, a BBC investigation, and the Scottish Executive's subsidies, review and early termination of the project. But the absence of any broader popular movement, it is difficult for the public, despite the legislation, to find out very much about these contracts.

In so far as PPPs represent a deliberate policy to increase the role of the private sector in the provision of public sector infrastructure, then information held by private sector companies is also crucial for accountability for public expenditure. While the *Freedom of Information Act 2000* enables the Lord Chancellor to designate private companies that supply public services as public authorities for the purposes of the Act, he has not chosen to do so. This prevents the public from seeking information about PPP projects from what are *de facto* public service providers, thereby curtailing the remit and effectiveness of the legislation.

### **The six stages of PPP projects**

The lack of information in the public domain about the economic need for a project undermines the government's case that the business need was demonstrated satisfactorily. Such information that is available about the decision-making and procurement process, largely the result of investigations by the public watchdogs, does little to reassure the public that either the decision-making or the procurement process, including the competitive pressure necessary to deliver VFM, was always satisfactorily carried out. Furthermore, it was clear from the scrutiny reports that the public authority had been unable to demonstrate conclusively that the A74M/M74 project was likely to deliver VFM and had not attempted to do so in the case of the Skye Bridge. But in the absence of such investigations, it is rarely possible for the public to know, much less ascertain independently, whether a sound financial case for private finance was indeed made, since a financial appraisal was either not required, not released or only released under the *Freedom of Information Act 2000* long after financial close.

It is of particular concern that the M6 concessionaire is able, via the arrangement to build a link road from the M54 to the M6 Toll Road on the strength of its refinancing gain, to determine road building policy

shielded from public visibility and scrutiny. A further implication is that the selection of road projects in future will be based upon whether they can be made to deliver a revenue stream at the expense of those that cannot, thereby distorting the planning process.

There is little information in the public domain about the nature of the contracts, the incentives and penalties, the monitoring regime and the arrangements for contract enforcement, due to reasons of 'commercial confidentiality'. However, the NAO (1998) reports that it was the government that decided to keep the business cases and contractual details for roads confidential. But while the government makes little information available to the public either as tax payers or end users, stock exchange regulations and investor demand mean that some financial and contractual information must be made available to the capital markets and credit ratings agencies to support the offer documents accompanying bond issues used to finance PPP projects. The credit ratings agencies' reports provide an interesting perspective on their understanding of the risks and benefits of investing in PPP bonds (Fitch Ratings, 2003; Standard and Poor's, 2002; 2003), although it should be remembered that they too have their own commercial interests in promoting the bonds.

### **Private sector accounting framework for the public sector**

The public sector has adopted a framework of reporting intended to meet the needs of shareholders as investors. This means that in the context of DBFOs, information of value to citizens, especially in relation to actual against expected expenditures, estimates of future expenditures, risk transfer, and contingent liabilities, is not reported as part of the annual report and accounts. While it may well be possible to obtain both budget and actual data, this may now be in different documents making comparisons less accessible, and aggregated across all PPPs. The separation of budgeted and actual expenditure and the aggregation of

PPP payments represent a loss of accountability. Not only is there a lack of clear financial information, the non-financial information about how satisfactorily or otherwise contracts are operating that is so crucial for assessing the degree to which the contracts incentivise the private partners to deliver the appropriate level of service, is also not disclosed.

In the private sector it has long been recognised that the presentation of consolidated accounts for large diversified organisations is problematic for shareholders because it disguises the risk profiles of individual segments. This is now being replicated in public sector consolidations where departmental accounts, made up of numerous public authorities, may disguise the risks involved in the turn to private finance.

Furthermore, the accounts provide little information about contingent liabilities associated with PPPs. This contrasts with a statement by a credit ratings agency (Standard and Poor's, 2003) that the government guarantees the Highways Agency's payments and has issued letters of comfort to support some of the special purpose vehicles' (SPVs) financing arrangements. It is not, however, known whether such arrangements apply for the cases in this study. But the lack of accounting information persists despite the fact that the government has had to intervene in a number of cases at the taxpayers' expense. This is not only a problem in relation to DBFO contracts. In freestanding projects, although there are no direct payments, there is still the political imperative to ensure that the projects remain open to the public in the event that the concessions collapse.

By way of contrast, Stock Exchange regulation in the context of public bonds issued by public authorities and corporations does require reporting of some additional information that would not otherwise be disclosed to the public. But this means that information is disclosed but located in a place where the public might not expect or look.

## Private sector reporting

PPPs raise several issues of concern. First, while the SPVs and their sub-contractors should be the source of horizontal accountability, their reporting is both limited and opaque. Second, their complex group structure means that there is little disclosure of related party transactions. Thus the web of sub-contracting and the accounting regulations that permit close companies to hide behind the ‘corporate veil’ make it impossible to see where public money is going and difficult to assess the total returns to the private sector. Furthermore, although the public authorities and the NAO have the right to examine the books of account relevant to the contract throughout the extended supply chain, there is as yet no publicly available evidence that they have done so. Thus, it is not just that the private sector does not provide the relevant information; the public authorities are complicit in this evasion of their collective responsibility for the reporting and control of public expenditure.

Third, there is variation in the treatment of the underlying DBFO assets between the public authorities, between the SPVs and between the public authorities and their corresponding SPVs. All three public authorities (the Welsh Assembly Government, the Scottish Government and TfL) reported the contracts as off-balance sheet, thus conflicting with the way that the Highways Agency accounts for its DBFO contracts. Of the three DBFO companies, two reported the assets as on balance sheet, whilst the third changed its treatment from on balance sheet to off-balance sheet during the period studied. Thus there was asymmetry in one DBFO. None of the SPVs explained their accounting treatment, which reflected their judgement of risk. This discrepancy in accounting for risk transfer may be because risk is so finely balanced that different parties are legitimately arriving at asymmetric accounting treatments. It may also be because of political pressure on the public authorities to report the assets off-balance sheet to accord with the macro-economic rationale for DBFO.

Fourth, the front loaded profile of payments means that the private sector has monies needed for future maintenance, which with roads typically arises some fifteen years after a new build. It is unclear that these monies have been subject to ring fencing to ensure their future availability when maintenance falls due. It is also unclear whether the public sector has asked for these monies to be ring fenced and whether its external auditors have checked that there is adequate provision made or that the private sector company remains financially viable.

Taken together, there is a lack of transparency that both limits and is exacerbated by the absence of reporting on the part of the public authorities. This in turn has implications for democracy in terms of how governments are held accountable for public money.

### **Cost of private finance**

The lack of information provided by the public authorities means that the main source of financial information relating to the cost of an individual project, notwithstanding its limitations, is the SPV's annual report and accounts. For ongoing DBFO projects, their accounts show that the annual cost of finance, once the projects became fully operational and were in steady state, represents the majority of revenues received from the project, between 64% and 83%. The annual financing cost of the M6 toll road was 88% of revenue. Thus, while the public, as users, has a clear interest in this financial information, it is not provided by the public authority.

Furthermore, the additional cost of private over public finance was about 20% attribute *ex ante* to the cost of risk transfer. But the high returns indicate that the adverse events priced into the contracts did not occur. This was not a unique finding but was observable across all the DBFO projects, and therefore raises questions about whether the appraisal methodology and process for assessing VFM was appropriate.

The Skye Bridge case demonstrates that in freestanding projects with user charges, there are risks to the public purse that the risk transfer methodology is unable to capture and quantify, and which the private sector reporting framework does not disclose as potential liabilities. Public opposition to the tolls was so great that ultimately the public authority had to bear the costs it had sought to transfer to the private sector, which had become much greater as a result of private finance. That is, the move to private finance may create additional risks for the public sector, as the experience of some toll roads in other countries has shown, so that the public as taxpayer has a legitimate interest in the reporting of such projects. Risk ultimately is a political issue, limiting the amount of actual risk transfer which is the justification for the policy. The corollary of this is that the private partners' rewards may not be commensurate with the risks actually borne.

It is striking that there has been no examination of the additional cost of private finance by the public authorities themselves, either during the operational phase or after termination, despite the fact that this is neither difficult nor time consuming to do. Neither has there been any *ex post* external scrutiny of the costs to assess VFM, the use of public funds, and inform the policy debate.

The additional cost of private over public finance on DBFO projects, assuming the same level of debt, is conservatively estimated at between 16% and 40% of revenues. Some of the variation between the projects may be due in part at least to the variation in traffic volumes. The additional annual financing cost of the M6 toll road was estimated at 8%.

The additional cost of the completed projects, the Dartford Crossings and Skye Bridge, was similarly estimated very conservatively at 7% and 25% of revenues respectively. While comparisons with the cost of finance of similar publicly funded projects are difficult to make in this way because tolls were set to achieve different aims, the cost of finance over the original thirty year life of the Forth Bridge comparator

project was 51% of revenues. These findings confirm the concerns raised in the literature cited in chapter two about the cost of PPPs.

Although the estimated additional cost of private finance on these projects is attributed to the cost of risk transfer, the lack of information about the original bids, the expected and actual traffic flows, the expected and actual payments, any penalty deductions, the cost of operating and maintaining the roads, contractual performance and any contractual changes means that the public cannot assess whether such costs are commensurate with either the benefits and risks to the public sector or the risks to the private sector.

Furthermore, any additional cost of finance in DBFO projects is significant in the context of the public authorities' budget which must create affordability problems and in the context of cash strapped services drain resources from elsewhere. Thus under conditions where the maintenance backlog and the cost of maintenance are already a problem, the new roads and maintenance come at the expense of other roads, other public services and/or higher taxes and user charges/co-payments: that is, at the expense of the social wage.

But this study has broader implications. PPPs are one way in which the state has been hollowed out. The natural progression of this policy is to see the Highways Agency become transformed over time into an SPV-like organisation within the Department of Transport. Such a development places even greater emphasis on the horizontal accountability stream, because without it, the department cannot provide upward accountability.

The creation of markets in public infrastructure and services via PPPs, and taking such arrangements outside the scope of public finance, signify paradoxically the beginning of the end to public sector decision-making and control of procurement. This matters since the private sector's objectives lie with profit maximisation whereas the public sector's, at least in principle, lie with the public interest. The inexorable logic of the move to markets is that the private sector initiates its own proposals

for service delivery and submits its plans to the public authorities, as what are known as unsolicited proposals, which would entail the dismantling of public markets in favour of private markets. This in turn leads to an agency-like relationship between the private and public sectors in that the former delivers the services and the underlying infrastructure on behalf of the latter, thereby attenuating governance. Such a system needs extensive transparency and accountability if the public's needs and interests are not to be subordinated to those of the private sector and the VFM that lies at the heart of the Partnerships policy is to be achieved in practice.

This study has shown that there is a lack of transparency surrounding the contractual arrangements, which the government has argued are commercially sensitive and/or contain significant intellectual property, despite the fact that such schemes use public assets, may entail a state-backed monopoly and ultimately are the government's responsibility should they prove commercially unviable and/or publicly unacceptable, as the Skye Bridge demonstrated. But in the absence of full and timely disclosure and scrutiny, these projects may burden governments with a diversion of revenue streams and implicit guarantees whose impact on public finance may not become apparent for many years. Any implicit guarantees, of course, are not recorded and hence there is no warning mechanism if a government's exposure to such risk becomes excessive. Even if the government is aware of its exposure, but especially if it is not, the real problem, Irwin *et al.* (1999) argue, is that an economic crisis could trigger all such guarantees simultaneously, so that contingent liabilities from a range of projects could become actual and current all at once, with the prospect of sudden and substantial obligations due over a short period of time.

The implication is that these guarantees have not been disclosed, and are therefore not made known to the public in the public authorities' annual accounts, because the government believes that the possibility that they would be called upon is remote. However, the private sector,

in disclosing any guarantees to potential investors, appears to be taking a rather different perspective – that such guarantees would give comfort to investors, improve their credit ratings and thus lower their cost of borrowing. Indeed, the capital markets themselves require this information to be available to potential investors. Such a disclosure provides a fundamental rebuttal of the government's justification for refusing to disclose information about PPP projects on the grounds of commercial confidentiality

In so far as the information is in the public domain, albeit unknown to a wider audience, this suggests that the government and the private sector companies are reluctant to disclose the information to the public at large. But reticence on the part of the government is not confined to PPP. In the context of rail, the public learned about the additional subsidies given to the train operating companies over and above the terms of their franchises from the companies' press releases to shareholders, not from the public authority responsible for such subsidies. Indeed, the companies themselves reported that there were gagging clauses in their contracts that prevented them giving detailed interviews to journalists (Shaoul, 2006).

The findings from this study are important because the scale and nature of the problems identified in a sector such as roads, whose projects are large and visible, are such that they are likely to be found elsewhere. In non-departmental public bodies where reporting is more diffuse, the accountability issues may be even more problematic. Furthermore, other forms of private finance are proliferating, not just the contractual and joint ventures/ownership models defined by the Treasury.

In short, the lack of consistent, comparable, and understandable financial information in the context of PFI makes it difficult for public sector stakeholders to understand where public money is going, how it is being used, and the extent of future commitments and liabilities. This makes it all but impossible to determine the implications for future government expenditure and perhaps even more importantly,

the extent of government's implicit debt, which is clearly mounting. This is not to say that there were ever any 'good old days'. Rather, the increasing expenditure outside the direct control of the public bodies creates additional reporting problems that make scrutiny, control and thus accountability difficult if not impossible and in turn create the potential for waste, mismanagement, and fraud. Under such conditions, the government increasingly rests upon shaky economic and financial information that will ultimately undermine the very basis of its activities and policies.

Finally, the absence of clear financial information not only makes an informed public debate about public and fiscal policy impossible, it may also lead to the wrong policy choice. More fundamentally, public discourse itself becomes meaningless. It ceases to be about finding solutions to broader social problems but becomes an exercise in justifying decisions already made.

## **Summary, further research and recommendations**

This study has shown that the reporting by the public authorities does not provide the necessary level of information about PPPs and future expenditure commitments and potential liabilities. Furthermore, although information about how satisfactorily or otherwise contracts are operating is crucial for assessing the degree to which the contracts incentivise the private partners to deliver the appropriate level of service, this non-financial information is also not disclosed. Not only is there little transparency, there is little external financial scrutiny of PPP projects. Scrutiny tends to occur as a function of public or media disquiet. In the case of roads PPPs, as opposed to the more politically charged services such as healthcare, there has therefore been limited scrutiny, since these generally have not attracted public attention. The Skye Bridge is the exception that proves the rule: there is paradoxically little interest from the majority of the public in such financial information (Hyndman and

Eden, 2001), as long as the quality of the service is being maintained (Bovaird, 2004) or until there is service or financial failure.

Although governance guidelines currently blend traditional public sector values and corporate governance style mechanisms of oversight, practice is most strongly influenced by private sector accounting and corporate governance. While accountability 'for what' has connotations of both internal behaviour and externally assessed performance, the reporting focus is on financial controls, which do not explain how and why resources have been utilised or how well services have been delivered. While the rhetoric of reform emphasised increased accountability to service users and taxpayers, in practice the institutional arrangements focused on the public authorities' responsibility upwards within the public sector hierarchy. Downward accountability is unlikely to happen in practice since the guidelines offer limited advice about how it may be operationalised. This is compounded by the lack of public access to information, particularly in terms of transparency in decision-making. There is therefore a gap between the rhetoric of public sector reform and practice. Thus accountability, even in its simplest form of giving and demanding reasons for conduct, is limited, while the more complex form of accountability that involves government in a critical evaluation of its own policy is more limited still.

Future research might investigate the practice of governance in the public sector, since this study suggests a gap between the practice of governance and the rhetoric underpinning public sector reform that it would benefit users and taxpayers.

As a result of the policy and the reporting practices, it is therefore impossible for the public to understand: (i) the degree to which the anticipated benefits of PPPs are being achieved in practice; (ii) the impact of large projects on budgets in terms of present and future affordability; and (iii) the sustainability or otherwise of public expenditure.

When calling for more disclosure, which is clearly necessary in respect of PPPs, it is important to be mindful of both the costs and benefits associated with information provision. The recommendations

are targeted in four areas: (i) guidance to public authorities; (ii) quality of annual public sector information; (iii) information about the private sector partners; and (iv) information release. Each is considered in turn.

### **Guidance to public authorities**

Various international as well as national entities such as the Treasury, CIPFA and the Audit Commission provide guidance to public authorities on reporting and accountability issues, for example the recent Treasury guidance on implementation of IFRSs (Treasury 2008b). Governance guidance to public authorities should include:

- The specification of how horizontal and downward accountability streams to private sector partners and citizens are expected to operate in the same way as the upward accountability stream to Parliament is recognised. That is, the intended mechanisms by which governance of the partnership relationship and accountability to citizens are to be achieved should be specified in a manner similar to the guidance that is provided about the role and duties of the accounting officer;
- The development of guidelines, based upon experience gained from the profile of Freedom of Information (FoI) requests, leading to greater routine disclosure of information relating to PPPs. That is, FoI requests to one reporting entity should form the basis for new forms of reporting throughout the public sector, so that eventually the numbers of one-off FoI requests decline;
- A common approach to locating financial information should be recommended for public sector websites;
- The requirement for public authorities to publish succinct summaries of long legalistic contracts.

## Quality of annual public sector information

Public authorities already produce information that could and should be released. Presently such information is aggregated in public sector accounts, so the recommendations below focus on the disaggregation of such data:

- Disaggregated information about the costs of large PPP schemes should be routinely provided in the accounts to improve data collection by the Office for National Statistics (ONS) as well as for accountability purposes;
- Disaggregated information about individual large-scale PPPs should be reported in the accounts to provide information about the current year's payments, expected payments and future commitments;
- There should be a breakdown in the accounts of the unitary charge between availability and service elements, and amounts deducted for poor performance;
- An explanation of the risk assessment leading to any off-balance sheet treatment for PPPs should be disclosed, making the judgement reached under *FRS 5* and *IFRIC 12* clearer;
- Information on all contingent liabilities together with assessments about the probability of crystallisation should be reported by the public authorities and collated and published by the Treasury in accordance with the recommendation from the EU (EMU, 2003) that quantitative information about contingent liabilities should be disclosed;
- Actual and budget revenues and costs should be compared and disseminated in the same document with an explanation as to why large variances have occurred.

## Information about private sector partners

Better control over the private sector partners must be established and better access to data obtained. Recommendations include the following:

- All public authorities should provide comprehensive details on their PPP projects to the Office of National Statistics (ONS) so that the ONS can create a complete list of SPVs and their PPP related debt;
- Public sector external auditors should use their power to roam through the extended supply chain, and determine if partners are viable and specifically that adequate provisions exist for future maintenance costs on PPP projects;
- Provisions in contracts to ring fence front loaded payments ought to be enforced by the public sector procurers to ensure the future viability of these long term contracts, and disclosed by the private sector partners;
- The Lord Chancellor should designate private companies that deliver public services as public authorities for *Freedom of Information Act 2000* purposes.

## Information release

Lack of information in the public domain seriously reduces independent evaluation of PPPs, yet there already exists documentation that would assist the public understanding of project development and assessment. Such information is sometimes released by some but not all public entities. The following information should be released by all entities on a timely basis:

- Public authorities should routinely publish their business cases after financial close;
- Public authorities should conduct 'Gateway Reviews' for all PPP type projects, irrespective of start date, and publish them in an agreed timeframe;
- There should be an agreed limit on the time period when commercial confidentiality may be used as a rationale for non-disclosure.

Without implementing such recommendations, public authorities cannot provide the public with the information needed about the costs, VFM and affordability, or the sustainability of public expenditure, public debt and the government's implicit liabilities.

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# Financial Black Holes: Accounting for Privately Financed Roads in the UK

Recent years have seen a change in how public assets are financed with a move towards more private finance, particularly in the transport, defence, health and education sectors. This change in policy and the additional complexity involved in such schemes raises important questions for reporting and accountability. How can the public understand where public money is going, how it is being used, whether it is value for money, the risks involved and the extent of future commitments and liabilities?

This report examines whether the current reporting and disclosure for privately financed projects in the road sector delivers accountability for public monies. The report finds that the reporting by both the public and private sectors is limited and opaque; the cost of finance is a significant cost and significantly more than public finance; and that the financial costs of such schemes are subject to little ex-post external scrutiny. The lack of information makes it very difficult for the public to assess whether the additional costs involved in private versus public finance are commensurate with the benefits and risks to the public sector. The authors conclude with far reaching recommendations for public private partnerships across the public sector.

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