2128/1

050

qc [illegible]

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 4499

A Turnbull
Under Secretary

P R C Gray Esq
10 Downing Street
LONDON
SW1

9 February 1988

Dear Paul,

PRIVATE FINANCE IN PUBLIC EXPENDITURE

I attach a copy of the note which the Treasury prepared in response to a request from the Civil Engineering EDC. The NEDO Secretariat will be releasing it to the Construction Industry Group (the successor the Civil Engineering EDC) and to the press on Thursday 18 February. We are proposing to place a copy in the House of Commons and let this be known by a Written PQ on that day.

There are two No 10 interests. First, the paper builds on the earlier exchange with the Civil Engineering EDC when the Prime Minister wrote to the Chairman. This could lead to requests from the press to see the latter. Could you confirm that you see no problem with this? Although the Treasury Press Office would expect to handle most of the enquiries, an approach could be made to No 10.

Secondly, John Wybrew is advertised as speaking at a seminar on private finance in Oxford on 18/19 February organised by the Major Projects Association. He would no doubt welcome a copy of the note.

I am copying this letter to Alex Allan in the Chancellor's Office and Jill Rutter in the Chief Secretary's Office.

Yours sincerely

Andrew

A TURNBULL

PRIVATE FINANCE IN PUBLIC EXPENDITURE

Background

The Prime Minister wrote to Mr David Stevens (now Lord Stevens), the Chairman of the Civil Engineering EDC, in October 1986 setting out the Government's approach private finance for public sector projects. This note explains the thinking behind that approach more fully. In particular, it puts that approach in the context of the increasing role of the private sector.

2. As the Prime Minister's letter made clear, the Government welcomes the use of private sector finance and expertise in improving the enterprise and management efficiency with which services can be delivered. Privatisation, that is transferring the responsibility for providing a service such as telecommunications wholly to the private sector, is the most complete way to secure this. Where the public sector retains responsibility to provide a service, other ways of getting the private sector to provide an input to that service, such as contracting out, can be valuable where they are more cost-effective than provision from within the public sector.

3. Similarly, where the public sector would otherwise have invested in a capital project as part of the provision of a service, the introduction of private finance for the capital project is welcomed, if the proposal is more cost-effective.

4. The Prime Minister's letter raised three issues:

a) what projects are relevant to the discussion;

b) how the choice between public or private sector finance should be made;

c) what are the implications for the Government's existing expenditure plans and limits?

Identification of projects

5. The Prime Minister's letter was directed at privately financed projects of a kind which would otherwise be financed by the public sector. For the foreseeable future, there will be a wide field of such projects in such areas as public health, public education, law and order, roads and many other activities of Government.

6. Schemes in this field may come in a number of different forms. In some cases the private contractor is allowed to levy charges on the private sector so the public sector is not directly involved, as is the case with the Dartford crossing. In others, the private sector acquires or constructs a capital asset which it makes available to the public sector in return for which the public sector accepts a liability to make a flow of payments (or give up a flow of future expenditure savings) in the longer terms. But in each of these cases, the public sector is relieved of an obligation to undertake capital expenditure in the short term, in return for higher payments or lower receipts later on. One characteristic of these schemes is therefore that they are akin to borrowing, in the broadest sense.

7. Although the most obvious cases involve the offer by the private sector to finance a capital investment project, in other cases the contractor may offer a service in which the financing of a capital asset forms a significant part. If so, the nature of the service may need to be examined to see how far the financing element embodied in it can be distinguished from the rest of the activity. Guidance on these lines has been issued to Government departments in respect of contract energy management schemes.

8. At the other end of the spectrum from the continuing activities of Government are the projects and activities that have been or are being transferred entirely into private hands. Telecommunications, gas and many bus companies are instances. In these cases, responsibility for providing the service has been taken entirely out of the public sector.

9. Between these two classes are activities where the boundary between public and private provision is subject to progressive

rather than once-for-all change. Housing is a major example, but there are a number of other areas at the fringe of Government where it is not yet clear either that they could be placed fully in the private sector or that the alternative to private financing is necessarily public sector finance. In some cases services may be supplied by the private sector but supported by a degree of subvention from a public authority. The Government welcomes a greater private sector role in these "grey" areas.

The choice between conventional and private finance

10. The use of private finance instead of public finance for a specific project is justified if, and to the extent that, it provides the most cost-effective solution. Publicly and privately financed investment options should therefore be compared using standard investment appraisal techniques. When comparing publicly and private finance options, the appraisal will take account of differences in financing costs; and the fact that transferring to the private sector the risk of project overruns, or a failure to secure the benefits of investment, may provide a strong incentive to the private contractor to achieve greater efficiency than would be achieved by the public sector. The risk of losses - unprotected by public sector guarantees - is at the heart of market disciplines and the assessment of these extra incentives provided for the private contractor is a key element.

11. These factors lie behind the Ryrie Rules which were drawn up by NEDO in 1981 in the context of nationalised industries - at Appendix A.

Implications for existing plans and limits

12. The use of private finance does not of itself create additional resources. Borrowing by the private sector to finance a public sector project has much the same macro-economic effect as borrowing by the Government to finance conventional public expenditure. The Government's objective is to reduce the proportion of national income pre-empted by the public sector. It is therefore necessary to guard against private finance being

used as a backdoor way to the expansion of public sector activity.

13. Where there is effective market discipline, the market can be expected to redistribute resources to match demand. For those services where supply remains wholly or predominantly the responsibility of the public sector, the Government needs to ensure that the balance of activity between different public expenditure programmes reflects its own priorities. Changes to these priorities should be a deliberate decision, rather than emerging through the addition of private finance in varying degrees to different programmes.

14. For continuing activities of the Government that would otherwise be financed by public expenditure the normal presumption is that projects should be ranked by priorities, and accommodated within existing expenditure provision; unless Ministers deliberately decide they should be additional. This applies whether the finance is public or private. As the Prime Minister made clear, the Government may decide, as in the Dartford case, that the importance attached to a new project and to schemes already in the programme is such that expenditure should be additional. This is a separate question from the finance of such projects.

15. The same presumption applies in a slightly different form in the intermediate category of services referred to in paragraph 9 above. The conventions governing public expenditure remain the same, and any decisions to add to public expenditure are distinct from the question of finance. However, where private suppliers are operating in a competitive market environment, it is not the task of Government to attempt to dictate the level of provision by the private sector. The Government will nevertheless wish to take into account this level in deciding, over a period of time, how much the public sector needs to do in the same area.

Local authorities

16. The arguments in this note apply to the whole of the public sector, including local authorities. Financing proposals, such

as financial leases, which transfer no significant risk out of the public sector are taken into account when determining the overall level of local authority capital expenditure. Other proposals can introduce effective market discipline and may fall outside that constraint. In order to achieve comparability between in-house and external tenders, legislation for compulsory tendering in direct Labour Organisations provides that the in-house tenderer must make a prescribed rate of return on the capital involved.

Nationalised industries

17. The principles also apply to nationalised industries. Where a proposal is classified as a financial lease the principles are already applied through the capitalisation of such leases. Private finance proposals which do not score as financial leases will be taken into account when setting the External Finance Limits and investment approvals by the same means as described above for programmes generally.

H M TREASURY
February 1988

APPENDIX A

PRIVATE FINANCE FOR NATIONALISED INDUSTRY INVESTMENT: RYRIE RULES

An NEDC working party on nationalised industry investment was set up in June 1981 under the Chairmanship of Sir William Ryrie (then Second Permanent Secretary to HM Treasury) following NEDC concern that EFLs were frustrating nationalised industry investment and belief that a higher level of investment would benefit the economy. The working party, which presented its report to the NEDC in September 1981, devised the following criteria under which private finance might be introduced:

(i) decisions to provide funds for investment should be taken under conditions of fair competition with private sector borrowers; any links with the rest of the public sector, Government guarantees or commitments, or monopoly power should not result in the schemes offering investors a degree of security significantly greater than that available on private sector projects;

(ii) such projects should yield benefits in terms of improved efficiency and profit from the additional investment commensurate with the cost of raising risk capital from financial markets.