An Easter egg hunt

The £95 million that private companies extracted from a hospital project was not a mistake, but a deliberate gift

Whenever a new scandal about the private finance initiative (PFI) emerges, the government and its friends in the financial press blame it on "teething problems". When the first contracts permitting private companies to build and run our public services were signed, the argument goes, our civil servants didn't understand that they were being fleeced. If only they had known then what they know today, they would have obtained better value for public money.

This, for example, was the argument made by the Financial Times last week, in response to the latest revelations about the "refinancing" of the Norfolk and Norwich University Hospital – which allowed a group of private companies to carry off a windfall of £95million. "Acquiring wisdom can be an expensive business," its leader sighed. "Public sector and private companies now know much more about the private finance initiative than they did when it began". The "hard lessons" they learnt will ensure that such mistakes will not happen again.

This story, though endlessly repeated, is nonsense. The bonus the corporations found in the hospital contract was not a mistake. It had been left there deliberately. It was a sweetener, hidden from the public, which was designed to make the private finance initiative attractive to private capital.

The new report on the hospital's refinancing, published last week by the House of Commons Public Accounts Committee, explains how the Octagon consortium – a

collaboration by Barclays, Serco, John Laing, 3i and Innisfree – managed to treble its rate of return on the hospital scheme, from 19% to 60%. In 2003, five years after signing the contract, the corporations renegotiated the loans they used to build the hospital, obtaining lower rates of interest while increasing the payback time. This enabled them to extract their money – to great financial advantage – at the beginning of the project, rather than taking it gradually all the way through. In doing so, they managed greatly to reduce their own financial risk, while increasing the risk to which the hospital trust is exposed.

The trust, understandably, felt it was entitled to a share of the new money. But because there was no provision in the contract granting it any rights to a refinancing windfall, it had to make the most extraordinary concessions to obtain the miserly portion – £34 million – it eventually extracted. It agreed to pay up to £257 million more than it would otherwise have done if it ends the contract early. To help the investors extract more money, it agreed to extend the length of the contract from 34 years to 39. As it is impossible to predict clinical needs so far in advance, this increases the risk that the NHS will end up paying for services it cannot use. Unlike the companies, which took their share of the new money immediately, the hospital trust will receive its portion over 35 years. The chair of the public accounts committee – a Conservative who seldom loses sleep over excessive corporate profits – described the deal as "the unacceptable face of capitalism".

All this appears to position the Norfolk & Norwich NHS trust – which negotiated the contract – somewhere on the spectrum between naïve and raving mad. But it was nothing of the kind. It knew that the original deal offered terrible value for public money. But it had no choice. It was instructed to accept the corporations' terms by the Department of Health. Because this information was not included in the committee's summary, it was ignored by the press. But it is a theme to which the rest of the report keeps returning.

"Although the Department was aware of the potential for refinancing when entering this contract," the MPs reveal, "there was no contractual arrangement to share in refinancing gains". Once the re-negotiation began, the hospital was unable to demand more than 29% of the new money because "the Department … considered that it would have been inappropriate for the Trust to seek a larger share". The trust decided to take its money over 35 years, rather than immediately, "under guidance from the Department". As one of the Labour members of the committee, Ian Davidson, pointed out to the man from the health department, "it seems to me that you were tying hand and foot the trust in terms of what the limits of their expectation ought to be."

Last week a spokesman for the hospital trust told me that it was "very much alive to

the prospects of refinancing and wanted to include it in the contract. The advice centrally was to drop that issue. The Department was not keen to frighten the horses."

After the report was published, another of the committee's members, the Conservative MP Richard Bacon, spelt it out still more clearly on his website. "The Department of Health would not allow the hospital to include a refinancing clause in the original contract. This meant the hospital had no right to receive any proceeds from the refinancing at all, let alone the 29% share it eventually secured. And that right was only obtained by taking on huge extra potential liabilities."

"The Treasury had guidance specifically saying there should be no refinancing clauses," he told me. "It was a lure to get the private sector involved. ... Ultimately it all stems from Treasury guidance. It was the Treasury prohibiting refinancing clauses."

The deal, in other words, was an Easter egg hunt. In order to persuade the corporations to participate, the government left an extra £95m in the contract for them to find. This money represents the difference between the financial risk the government claimed they would carry and the far smaller financial risk (attracting lower rates of interest) to which they were actually exposed. While the drafting of the contract began under the Tories, it was completed, by Labour, in 1998. By forcing the trust to strike a bad deal, the government appears to have been negotiating on behalf of the corporations and against the public interest.

The Treasury's press office wouldn't answer my questions on the grounds that it was "a Department of Health issue". The Department of Health told me that the government had not demanded a refinancing share in its early PFI contracts, because that would not have offered "value for money". If the department believes that letting private companies walk off with £95 million of free money represents good value, it's not surprising that the NHS is in crisis.

If it is true that this handout was a deliberate government policy and that the Treasury was ultimately responsible, this surely provides more evidence that those who see Gordon Brown as the radical alternative to Tony Blair are deceiving themselves as much as those who believed that Blair was the radical alternative to John Major. Brown did not invent the private finance initiative, but he keeps it alive, however many scandals it produces. His record on this issue suggests that he has established his reputation for prudence by two means: by loading future generations with debt in order to balance the books today, and by filling the coffers of the corporations to win himself friends in the financial press.

While I will join the dancing in the streets when Tony Blair goes, I am mystified by the left's enthusiasm for his successor. Why should we welcome the appointment of a man who treats public services as a pension fund for fat cats?