

PFI and beyond -  
Separating fact from fiction for future success

## Introduction

The government estimates that £200 billion of investment in social and economic infrastructure is required over the next five years. Due to fiscal pressure, about 70% of that - c£140 billion - will have to be sourced through private sector investment. Failure to find this investment could damage the UK's prosperity and limit the ability of the private sector to grow the country out of recession.

There are various methods governments can use to inject private investment into public infrastructure. The most high profile of these is the private finance initiative (PFI). Introduced by the Conservative government in the early 1990s and expanded rapidly under the Labour government after 1997, the PFI has been responsible for the construction and maintenance of hundreds of schools, hospitals, defence projects, prisons and roads.

Despite an expanding and maturing market, the PFI has been beset by political furor mixed with a lack of data to compare value for money with traditional, publicly-funded procurement. Without a measured debate we risk losing some of the real benefits the model has given us. We also risk putting off future potential investors from supplying capital for vitally important projects. With investors increasingly looking to foreign markets, this risks damaging the UK's competitiveness.

This report aims to put together what we do know about PFI, tackle some of the myths surrounding it and look to the future.

### PFI key facts

- There are nearly 700 signed PFI projects with a capital value of £53 billion<sup>1</sup>.
- Education, health and defence account for more than half of the total by value.<sup>2</sup>
- 10 - 15% of total investment in public procurement is through PFI.<sup>3</sup>
- Since the May 2010 election, the government has signed 34 PFI contracts with a capital value of £1.8bn. At least another £5bn worth of deals, including waste recycling plants and big hospitals in Liverpool, are in the pipeline. In addition, Michael Gove, the education secretary, has just announced £2bn of deals for up to 300 schools.<sup>4</sup>
- PFI was pioneered in the UK but is now a successful export business. Over 100 countries looking to implement PFI/PPP procurement techniques and with over 40 countries already having some form of PPP unit to oversee implementation of projects.

<sup>1</sup> Parliamentary Question, Michael Meacher MP, 14 June 2011, Hansard, Column 702W

<sup>2</sup> Ibid

<sup>3</sup> HM Treasury, 2006, *PFI: strengthening long-term partnerships*

<sup>4</sup> Financial Times 7 August 2011 *Public finances: A divisive initiative*  
<http://www.ft.com/cms/s/0/fdb098aa-c138-11e0-b8c2-00144feabdc0.html#axzz1UQw8TRCk>

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- Most PFIs are built close to the agreed time, price and specification. In an NAO sample, 69% of PFI construction projects between 2003 and 2008 were delivered on time and 65% were delivered at the contracted price. Of those delivered late, 42% were delivered within six months of the agreed time and under half experienced price increases. Under traditional procurement, 65% ran on time and 54% were delivered on budget.<sup>5</sup>
- A survey on the performance of operational PFI contracts found that 94% of the 151 contract managers surveyed felt that the contract service levels were always or almost always achieved. 92% found that user satisfaction assessments indicated that services were being delivered to a satisfactory standard.<sup>6</sup>
- Public bodies using PFI are normally satisfied with the services provided by contractors. High levels of satisfaction are normally reflected in NAO reports.<sup>7</sup>
- When making changes to operational contracts, 90% of contract managers were either satisfied or very satisfied with changes made.<sup>8</sup>

### **PFI: A better understanding**

Arguments for and against PFI have been exercised repeatedly over the years. The detractors condemn PFI as being inflexible and expensive, a drain on non-PFI public service budgets and a way for governments to evade public spending rules and fudge national accounts. They also deny real risk transfer takes place. Those who support it say the opposite. As with most things, the truth is more complex than either of these polemics. Some projects have been a resounding success, benefiting communities for generations to come with new facilities, whereas some have failed and been the subject of rigorous investigation and political dispute.

Analysis of PFI is compounded by two factors. First, that many perceived weaknesses of PFI reflect instead the shortcomings of public sector procurement or project management and as such problems would have arisen under any model. For instance, client specification being wrong could happen under any route. Poor demand management and facilities no longer being needed are not caused by PFI but by poor planning.

Second, inconsistent comparison occurs because the public sector has not historically kept detailed records of the whole-life costs or performance of its traditionally-procured buildings. For instance, PFI often appears more expensive because it is the only route that includes all costs accurately over the life of an asset.

This section aims to clarify some misunderstandings about PFI. BSA members want to be part of a more constructive debate about the future of PFI for the sake of the UK's prosperity and competitiveness.

### ***PFI in its place***

The first myth that needs expounding is that PFI is some kind of panacea. This particular procurement model sits amidst an array of procurement models available to public organisations. It accounts for only 10 - 15% of public spending on infrastructure. Unless PFI is viewed in the wider context of public procurement, the positives and negatives will be taken out of context.

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<sup>5</sup> NAO, 2009, *Private finance projects*

<sup>6</sup> Partnerships UK, 2008, *Investigating the performance of operational PFI contracts*

<sup>7</sup> NAO, 2009, *Private finance projects*

<sup>8</sup> NAO, 2010, *Making changes the operational PFI contracts*

### ***PFI and flexibility***

One commonly held view about PFI is that it locks procuring authorities into long-term (~25 years) contracts, which in turn locks out flexibility. This means it is difficult for a public sector authority to make changes to its requirements over the life of a building. These can be small changes, such as layout, or more complex ones, such as changing the purpose of a building.

Because of the long-term nature of these contracts, PFI does rely on clear, upfront specification in order to optimise a series of asset management and investment tradeoffs. This means PFI tends not to be suitable where substantial flexibility is required and lessons have been learned in this area. For instance, IT services are no longer subject to this type of procurement.

However, the reality of the provision of complex capital assets, such as hospitals, is that once designed and built, subsequent major changes to the asset can be difficult to implement. This applies whether or not the asset was procured by traditional means or PFI.

In many cases, the fact the service cost is built in to a PFI is a useful rigidity as it prevents governments substantially changing budgets on a regular basis and storing up greater costs down the line. To argue for short-term budget flexibility on a complex asset risks saddling future taxpayers with a disproportionately higher backlog of maintenance work.

### ***PFI and the cost of finance***

PFIs typically use around 90% debt finance and 10% equity funding. The debt finance is in the form of bank loans or, prior to the credit crunch, bond finance. The equity finance is provided by contractors or financial institutions, and comprises of a mixture of shares and loans.

Because borrowing from private markets is more expensive than government finance, the costs of PFI are typically 3-4% higher than the cost of traditional procurement finance.<sup>9</sup> However, using this factor on its own to disregard PFI is not appropriate. Only 17% of annual PFI payments relate to private finance. A further 54% goes on construction and 29% on operations.<sup>10</sup> This means that efficiencies on either of these can easily outweigh the higher finance cost. A well-written PFI contract and a proficient public sector project management team mean that this should not be of concern.

In addition to this, the higher cost of finance is only in the early years during the construction phase. Most deals get refinanced once the project is operational at far lower cost and 50% or more of gains go to the government. This condition was added following the notorious investigation into the refinancing of Norfolk and Norwich hospital PFI.

A further element to this is that of interest rates. The majority of PFI schemes were negotiated in a time of high interest rates, typically 6-8%, and borrowing was more relaxed than at present. In a report for the Department of Health, McKinsey recommended NHS trusts with PFI buildings should renegotiate their interest rate charges - taking advantage of the fall in rates from 5.5 per cent in 2008 to 0.5 per cent in 2009.<sup>11</sup> It concluded that up to £200m could be saved a year if trusts did this. It remains the case that it could be worth exploring the possibility of using the government guarantee to renegotiate the interest charges and this is a discussion which continues between government and the private sector.

### ***PFI and risk transfer***

One of the fundamental aims of PFI is to transfer risk to private sector partners. This follows the logic that whoever is best able to manage a particular risk should be responsible for it. Risks include financial, legal, performance, construction and changes to policy. Whether this actually

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<sup>9</sup> NAO, 2006, *Update on PFI refinancing and equity market update*

<sup>10</sup> Ibid

<sup>11</sup> Department of Health, 2009, *Achieving World Class Productivity in the NHS 2009/10 - 2013/14: Detailing the Size of the Opportunity*

happens in practice is often at the centre of dispute. Detractors claim that real risk transfer does not take place because of an implicit guarantee by government that a project cannot fail. In addition, some claim that although the private sector partner takes on the risk of ensuring a facility is built on time and to budget, this is costed into the contract at a premium. Some estimate this premium costs up to 30% of the total construction costs.<sup>12</sup>

A picture is presented of a private sector that pulls the wool over the eyes of the public sector on two accounts, first by over-charging to take on the risk, and then by not actually taking it on. However, PFI creates a market where there are both winners and losers. If PFI did not transfer risk then it would not be the case that PFI companies have made substantial losses. For example, the termination of the National Physical Laboratory (NPL) project, following a number of delays and difficulties, cost the private sector an estimated £100m, with one BSA member bearing the majority of this loss.

And it is not just the construction phase that can create significant losses. The risk transfer takes place at the start with construction, but then continues throughout the contract with service delivery and life-cycle maintenance costs. Consequently, many sub-contractors to PFI companies have also lost substantial sums delivering on their contractual commitments. Under a PFI, the public sector does not pay for that underperformance and the price for the delivery of specific assets and services is fixed, therefore, taxpayers are not exposed to these losses.

The primary instrument of risk transfer on PFI is placing the overarching risk with debt and equity over the whole life of the project and this cannot be achieved if the project is paid for up-front. This feature of PFI not only underpins the risk financially but also has a dramatic effect on the quality of planning that flows from capital being at risk. This cannot be replicated simply by process (e.g. commitment to better planning of projects by the public sector) for a variety of reasons tried and tested over time.

Because of these factors, the NAO has concluded that on the whole, PFI has been successful in transferring risk to the private sector: *Although ultimate responsibility for delivering the service remains with the public sector, private finance has delivered real risk transfer. Few private finance projects have failed, but when they have contractors and lenders have normally lost most, unless the public sector provided additional guarantees. The allocation of risk throughout calls for an active public sector role throughout, particularly in the case of risks retained by the public sector.*<sup>13</sup>

Some transferred risks may not be good value for money, for instance, insurance risk, but that is government choice and is not inherent to PFI. The use of standardised risk frameworks by HMT has helped government in this area and now means there is strong competition on an agreed basis.

### ***PFI and profit***

The contention here is that the private sector has made excessive profit out of the public sector to the detriment of taxpayers. The important word is 'excessive' as of course nobody should be surprised that the private sector makes a profit. To understand this better we need to separate the investors from the service companies involved in a PFI consortium.

Once the early risk of construction is overcome, investors are able to realise gains on equity sales of shares in PFI projects as well as through refinancing debt. Unlike refinancing gains, there is no requirement for gains from equity sales to be shared with the public sector. If investors are systematically making gains on share sales as well as from refinancing that would suggest they are regularly earning higher profits than were expected when contracts were signed. The Public Accounts Committee recently concluded that the taxpayer is not getting a

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<sup>12</sup> BMA evidence to Treasury Select Committee 2011

<sup>13</sup> NAO *Private finance projects*, October 2009

good deal from this and that the Treasury does not have a full picture of the situation because it does not monitor the extent of these gains.<sup>14</sup>

However, primary investors assume development risk over the years that it takes to bring assets into operation. What is often described as excessive profit should be judged against the development risk. Any attempt to share or minimise that profit to levels that are not commensurate with the risk would erode investor appetite.

This also does not reflect the experience of service companies involved in PFI. These are the companies who deliver the maintenance services over the life of a contract. Very few projects generate above average returns and there are a number of cases where companies have lost money, even entering administration.

### ***PFI and value for money***

Some hold the view that PFI is a bad deal for the public sector and the taxpayer. Within this view is a bundle of assumptions about service quality, cost and public money being mis-directed. To determine whether value for money is achieved it is important to understand 'whole-life' costing and the way that private finance operates.

Maintenance of public sector assets tended to be inconsistent and in difficult economic times, sometimes non-existent, leaving a legacy of dilapidated assets. PFI, on the other hand, transfers whole-life risk from the public to the private sector. The company building the asset is very strongly incentivised to build something which is high-quality, not just on day one, but over the life of the contract. This has improved the quality of procurement, planning and building.

PFI therefore provides cost-certain, long-term maintenance ensuring that the asset is returned to the public sector at the end of the project in the same condition it started. Of course, if an asset is not needed at the end of its life in perfect condition, PFI may not be suitable. Hand-back requirements should always be considered carefully.

It is claimed that poor service is hard to manage when locked into a 25-year contract because there is no incentive to improve it. But for a PFI provider, the main costs are upfront but it recovers that investment with payments staged over a 30 or so year period. Importantly, this is dependent on performance. If service does not meet pre-agreed levels, the provider does not get paid.

It is difficult to see how performance over the length of a contract could be better incentivised without putting private investment at risk like this. Inclusion of the concept has been attempted in other procurement approaches, but without long-term debt and equity at risk we believe those attempts are largely meaningless.

This also makes it important - for both the contractor and the public sector client - that performance is tightly monitored. This is in stark contrast to traditionally procured projects, especially over the life of an asset. One of the few studies attempting to compare the performance of PFI to non-PFI services - in this instance, hospital cleaning - showed that PFI facilities witness higher levels of cleanliness and quality of patient environment with no associated higher cost.<sup>15</sup>

### ***PFI and accounting transparency***

Any investment, whether PFI or not, should only be embarked on if it represents value for money and is based on need and affordability. This seemingly obvious statement has been muddied for PFI because of its ability to record government debt off the national books.

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<sup>14</sup> PAC

<sup>15</sup> G Ive, A. Murray, A. Edkins, K. Rintala, 2010, *Cost and performance comparison of PFI and non-PFI healthcare infrastructure in England*

It is therefore often alleged that PFI projects would not have happened if it weren't for this accounting trick. The debate over this is often political and there are two main schools of thought. First, a government is not going to want to be remembered for storing up debt so if it was not for off-balance sheet accounting, decades of underinvestment in public infrastructure would continue with schools and hospitals crumbling further. Second, because PFI borrowing is private, governments can enjoy the prestige of new buildings without having to worry about paying for them and so investment was often unnecessary and PFI was wrongly picked over other, more appropriate procurement methods.

Regardless of the debate around accounting, this must not be confused with a lack of accountability. PFI offers cost and project transparency which is substantially ahead of other procurement approaches. Because private finance is on the line, risks are identified at the start of a project and so can be costed and managed. Under conventional procurement such risks are implicit only. It is no coincidence that PFI is promoted as a route to tackle corruption across much of the world.

### **The future of PFI**

As already discussed, PFI does not suit all projects and never has. It is right that there is no one-size fits all approach to infrastructure investment. We also believe there is a legitimate debate to be had around the future role of private finance and how data collection can be substantially improved. However, it would be a mistake to write-off PFI and would be a huge waste not to build on its strengths.

The NAO agrees and recently concluded that: *In the current climate, PFI may not be suitable for as many projects as it has been in the past. The lessons from PFI can, however, be applied to improve other forms of procurement to help government achieve its aim of annual infrastructure savings of £2-3 billion.*<sup>16</sup>

The Public Accounts Committee also agrees: *The government should be doing more to identify the circumstances where PFI works best, capture the lessons learned from PFI procurements and apply clear criteria to future decisions over identifying the best route for particular public infrastructure investments.*<sup>17</sup>

One such example of learning the lessons of PFI can be found in the education sector. In order to reduce the cost of bespoke school buildings, the recently published James Review recommended more use of standardised designs to simplify projects.<sup>18</sup> By allowing contractors to deliver efficiency savings through economies of scale we believe this would improve the affordability of school building projects.

In addition to encouraging the continuous improvement of the PFI model, we support the introduction of new models, giving the public sector more choice and the ability to meet new challenges. For instance, the following three models are worthy of further exploration and development:

- **Tax Incremental Financing (TIF)** has been used in North America for more than 50 years, particularly for urban renewal. The principle is that future gains in taxes, such as business taxes, can be used to leverage funds to invest in present day infrastructure projects. Used appropriately this model should result in income generation for the public sector, without the need for additional taxation. However, TIF itself does not provide any infrastructure investment. Extending local authority borrowing powers under the government's localism agenda is a welcome step towards encouraging this type of procurement.
- **Regulated Asset Base (RAB)** model has been used widely in the regulated utilities sector and has successfully funded projects in airports, energy and social housing. It works by

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<sup>16</sup> National Audit Office, 2011, *Lessons from PFI and other projects*

<sup>17</sup> Public Accounts Committee, *PFI in housing and hospitals*, 18 January 2011, HC 631

<sup>18</sup> Department for Education, April 2011, *Sebastian James Review of Education Capital*

holding down the cost of finance by regulating the prices paid by consumers. Other types of 'user pays' models have been used extensively in countries like Australia to fund economic development and regeneration.

- **Local Asset Backed Vehicles (LABVs)** allow local authorities to use their assets to attract long-term investment from the private sector to deliver socio-economic development and regeneration. Private sector partners are tasked with developing public sector assets and land. They then share the associated uplift in values, revenues and improved service provision. Of course, this model is dependent on the public sector having appropriate land or other assets to transfer into the joint venture vehicle and upon the market value of the land/asset that is available.

**Case study: John Laing's Joint Venture with Croydon Council** - the Croydon Council Urban Regeneration Vehicle (CCURV) illustrates how the public and private sectors can work together to develop innovative solutions for infrastructure re-provision through harnessing value from the public sector's asset portfolio. CCURV was the first partnership of its kind established in the UK. Through this 50/50 limited liability partnership (in which the council invests land and John Laing invests equity), the council will receive a 50/50 share in profits and will maintain ongoing control of its extensive regeneration agenda.