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# **Risk and Reward of the Private Finance Initiative in the UK**

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## **Abstract**

To date, the Private Finance Initiative (PFI) forms one of the key elements of the UK government's strategy to deliver modern, better quality public services and to reduce public investment by increasing private sector investment. Prior to April 2003, 570 projects have been let within the UK as PFI contracts, comprising a total capital investment of over £52 billion. Almost every central government department and local authority has used PFI contracts. It is claimed that most PFI projects have two main benefits: value for money and risk transfer from the public sector to private organisations. The PFI approach provides not only an asset, but also the long-term services required to run that asset over the life of the contract. Further, while the approach brings high potential benefits to both the purchaser and the supplier, it also generates additional risks over the long term and is thought to significantly increase the workload of contractors. This paper reviews the development of PFI in the UK, analyses the potential benefits and risks of the PFI approach and examines the problems currently encountered with PFI contracts. It concludes the most main benefits to be derived from PFI projects are the promotion of a clear sustainable strategy and the development of long-term operation skills within the private sector.

## **Keywords**

Private Finance Initiative, UK, Value for Money, Risk Transfer, Sustainable Strategy

## **1. Introduction**

While the UK Private Finance Initiative (PFI) was established in 1992, it developed slowly up until 1997. After the first review of Bates, however, and under strong promotion by the current Labour government, its growth accelerated. Currently, this initiative forms one of the key elements of the UK government's strategy to deliver modern, better quality public service and to reduce public investment by increasing private sector investment. Nationally almost all government departments countrywide have adopted the initiative. Additionally, it has also been described as providing the most significant challenge to the UK construction industry.

PFI fundamentally changes the government's procurement procedure for capital expenditure from the provision of an asset to the provision of a high quality service. At the heart of all PFI projects is the demonstration of two connected things: the achievement of value for money for public expenditure, which must be achieved, and the transfer to the private sector of "genuine risk" (PFP, 1995). Both value for money and risk transfer are two primary benefits demonstrated by PFI. In addition, PFI delivers a number of potentially significant rewards for both purchasers and suppliers. However, because of the long-term nature and the complexity of PFI contract, it also generates more risks over the life of the project. Risk allocation and management techniques are seen as crucial to the success of PFI project.

Currently, not all PFI projects are successful; they still face a number of challenges, such as high tendering costs and lengthy procurement procedures; difficult in partnership selection and operation; lack of experience of PFI in the public and private sectors; heavy workload within the private sector and a lack of sustainable strategy planning during the life of the contract.

This paper comprises four parts: the first part reviews the history of PFI, identifying the concepts relative to PFI, its scope and type; secondly, it summarises the potential benefits for both the public sector and the private sector; thirdly, it analyses risks within PFI projects and risk transfer from the public sector to the private sector. Finally it examines the challenges under PFI. It concludes that the two most important factors required to achieve a successful outcome for a PFI project are: the promotion of a clear sustainable strategy and the development of long-term operation skills within the private sector.

## **2. The Context of Private Finance Initiative**

### **2.1 The Brief History of PFI**

The origins and development of PFI in the UK have been successfully reviewed in a number of articles (Allen, 2001; The Scottish Parliament, 2001; Allen et al, 2002). They can be summarised as follows:

Prior to 1989, UK governments were not keen to use private capital to finance public sector projects. Their position was set out in the so-called “Ryrie-Rules”. The Private Finance Initiative (PFI) announced by Norman Lamont, in his 1992 Autumn Statement, superseded the Ryrie Rules.

*“The aim of introducing the PFI was to achieve closer partnerships between the public and private sectors at both central government and local authority levels. The guiding principles of the PFI are similar to those underlying the Ryrie Rules: ventures established under the PFI need to achieve a genuine transfer of risk to the private sector and secure value for money in the use of public resources...”*

In autumn 1993, he announced the creation of a Private Finance Panel (PFP) whose role was to encourage and stimulate new public procurement. In the autumn statement of 1994, Kenneth Clarke, the subsequent Chancellor of the Exchequer, ensured engagement with the private sector by making it plain that the Treasury would not approve any capital project unless options to secure private finance had been explored. This 'universal testing for private finance' was the culmination of a very determined policy by the then Conservative Government to ensure not only the survival but also the centrality of PFI in securing service/building developments in the public sector (Broadbent and Laughlin, 2003). In 1997, Sir Malcolm Bates published his first review of PFI, which made 27 recommendations to the government to streamline and improve the delivery of PFI projects. The Treasury Taskforce (TTF) was established to standardise procurement procedures, and to provide the relevant training for public employees. The second Bates review reported in 1999; its main recommendations stressed the importance of strengthening departmental deal making skills and the need to look at possible options for a successor body to the Taskforce. The Office of Government Commerce (OGC) and Partnerships UK (PUK) now undertake the work of the TTF. Partnerships UK, launched in June 2000, replaced the projects arm of the Treasury Taskforce. The formation of the OGC was announced in July 1999 and established in April 2000.

### **2.2 The Concepts of PFI**

The international project finance association (2002) defined PFI as:

*“The procurement of public services and assets by government and local authorities where the private sector is responsible for the design, construction, finance and operation of an asset or service for a specified period of time after which it is transferred back into the public sector. The public sector purchases the services from the private sector and pays a fee based on specified output criteria and usage. The private sector consortium uses the fee to repay loans taken out to finance the construction or refurbishment of the asset/service.”*

PFI has two important principles: value for money (VfM) and risk transfer. The first principle “VfM” requires that project costs are used efficiently and safely. The private sector is required to deliver the project under budget (agreed in the consortium) and to provide a good quality of performance. Another major principle of PFI is the transfer of risk from the public to the private sector, where the private sector is best placed to manage that risk (Grimsey and Graham, 1997). Allen (2001) states that PFI entails transferring the risks associated with public service projects to the private sector in part or in full. Where a private sector contractor is judged best able to deal with risk, such as construction risk, then these responsibilities should be transferred to the private sector contractor. Where the private sector is deemed less able to manage the project’s risks, for example, whether or not demand will be high enough for the services, then at least some of the responsibility must remain within the public sector.

Moreover, the Institution of Civil Engineering (ICE) identify a further three principles within PFI:

- Output specification: whereby the client specifies its requirement as a stream of services rather than the physical asset(s) through which they will be provided. This is also at the heart of PFI and should form the basis of payment by the public sector.
- Whole life asset performance: in which the private sector will be responsible for the asset it provides throughout its life cycle.
- Performance related rewards: in which the private sector partner is incentivised in the contract to achieve certain desirable levels of performance.

### **2.3 The Type and Scope of PFI**

Under PFI, three broad types of projects can be identified: financial free-standing projects; service sold to public sector and Joint Ventures (PFP, 1995). Financial free-standing projects are where the private sector undertakes the project on the basis that costs will be recovered entirely through charges for services to the final (generally, private sector) user. Service sold to the public sector is where the costs of the project are met wholly or mainly by charges from the private sector service provider to the public sector body which let the contract. The third type, Joint Ventures, involves a partnership whereby the Local authority, for instance, may not take on a role greater than 50% of the capital funding (PFP, 1995). In return the parties will receive a proportional share of any profits.

Up to April 2003, 570 projects have been let as PFI contracts amounting to a total capital investment of over £52 billion. PFI contracts have been used by almost every central government department and local authority. They include most types of public infrastructure: for instance, roads, prisons, hospitals, schools, office buildings, etc. Details of these projects can be found at the OGC PFI homepage <http://pfi.ogc.gov.uk/>.

### **3. Benefits**

PFI offers benefits to both the public and private sectors (PFP, 1995). The primary benefits for the public sector and for the public in general include: value for money and risk transfer. In 2000, Arthur Andersen and Enterprise LSE published a review of PFI, commissioned by the Treasury Taskforce, to examine the value for money aspects of operational PFI projects. Its conclusions were broadly supportive of Public Private Partnerships and PFI as a procurement mechanism. PFI, therefore, appears to offer value for money; however, projected savings are sensitive to risk transfer valuations that account for 60% of the forecasted cost savings. PFI allows the UK government to provide new infrastructure and services for minimal initial capital outlay and investment. Reforms already made to the PFI approach will lead to a significant increase in the contribution made by private finance to public-sponsored total gross investment, growing from 10% in 1998-99 to an average of 15% in 1999-2000 to 2001-02, in particular as PFI projects are brought on stream more quickly. Additionally, the recent NAO (2003) report shows that there is strong evidence that the PFI approach is bringing significant benefits to central government in terms of delivering built assets on time and for the price anticipated by the public sector.

PFI also offers significant rewards to the private sector, which include more predictable revenue streams, significant long term benefits, optimizing assets, greater control and management responsibility leading to reduced overheads, opportunities for innovation and whole life cost savings (PFP, 1995). A recent report (Unison, 2003) analysed how the top 10 construction and facility management companies derive their profits and concluded that although the high bid costs will affect some company's short term return, the private sector can still achieve the significant long term profits from PFI contracts. It highlights that PFI projects provide a new and more reliable source of profits than traditional building work, while Priddy (2002) found that PFI could offer a long-term, stable financial return to successful contractors.

Another significant benefit for the private sector is whole life cost savings. Whole life costing is currently an emerging issue on PFI projects. The whole cost of a project can be five times its capital cost, following the current theory ratio, 1:5:200. This presents the total cost of design and construction, compared to the total life cost of operation and maintenance, compared to the total lifetime cost of the business process in the building (Priddy, 2002). Additionally, the whole life cost approach, it is held, encourages good quality design and construction (NAO, 2003).

#### **4. Risks**

Understanding and managing risk is the key to achieving value for money in PFI projects. Risks can be modelled and measured, while establishing a risk framework is a fundamental requirement for an effective risk allocation and management process. The framework provides a structure that ensures that all areas of risk are considered and that risk is addressed consistently across all supplier negotiations (Ellis, 1999). These risks can be divided into two groups: internal and external risks. Internal risks are risks involved in the design, construct, and operation of the project, which can be transferred from the public sector to the private sector. External risks are difficult to manage and predict by the private sector. These risks are shown in Table 1. Previous research has identified and analysed both the internal and external risks of PFI projects (for example: PFP, 1995; Grimsey and Graham, 1997; Ellis, 1999 and Allen, 2001). In addition to the above, there is a further risk at the heart of PFI projects; that is interface risk. This is a risk contained within the partnership between the public sector and the private sector. Any failure in the joint management of activities, such as the handover from the contractor to the operator, could cause problems for the project and the Special Purpose Vehicle (SPV), and affect the delivery of services and hence the payment of fees.

**Table 1: The framework of PFI risks**

<b>Internal risk</b>	<b>External risk</b>
Design and construction	Development
Commissioning and operating	Market
Technology and obsolescence	Revenue
Finance and funding	Force Majeure
	Affordability
	Political (Tax, regulations)

Finally, a further risk discussed in the literature is environmental risk. This risk includes such factors as climate change, pollution, waste management, which might not be insignificant in the conventional procurement process, but may be over the life of a PFI project, which is normally 25-30 years.

## **5. The Challenges of PFI**

Not all PFI projects are successful; currently some face a number of challenges. These challenges include: high bidding costs and long term tendering procedures; difficulty in partnership selection and operation; lack of experience of PFI projects in both the public and private sector; lack of appropriate skills and an increase in the workload of the private sector.

The complexity of the process makes PFI an expensive procurement method for both the purchaser and supplier. BEC (1995) found that PFI tender costs are over six times greater than the costs of alternative forms of procurement; Neville (2000) established that the PFI procurement process usually takes two years longer than traditional routes. Furthermore, because PFI is still a new procurement system, both the public and private sector are engaged in a learning process, as both lack the experience of running PFI projects. Therefore, they lack the appropriate skills, such as value management, risk management, facilities management and those required to calculate whole life costs. Finally, the long-term nature and the complexity of PFI contracts increases the workload of private sectors, the supplier not only has to design and construct the asset, but also provide the financed investment, operating and external services to the public sector.

The two main factors that influence PFI project successful are the promotion of a clear sustainable strategy and the long-term operating skill of the private sector. For the long-term contract, it is essential to provide a sustainable strategy plan, which can monitor the project from the planning stage through to the disposal of the asset. The plan should be an effective analysis of all the risks and costs of the project. Secondly, the private sector needs to have to the professional long term operating skills to gain the maximum benefit from PFI.

## **6. Conclusion**

After a decade of PFI projects, the approach has become more mature. While value for money and risk transfer principles are achieved, PFI project could have robust, long-term benefits. Although a number of PFI contracts have been signed, to date, there are still no projects that have attained financial closure. It is too early; therefore, to arbitrary judge whether the PFI methodology is appropriate. PFI has the potential to offer several benefits and rewards for both the public and private sectors. It reduces public capital investment, provides quality and modern services and delivers the project on time and under budget. For the private sector, it offers whole life cost savings and stable, high long-term profits; it also provides more opportunities for private organisations to be innovative. All risks (internal and external) within PFI projects need to be

allocated and managed. Environmental risks should be taken into account on projects. Finally, PFI projects still face some challenges, which may cause project failure. In order to achieve a successful PFI projects consortia should promote sustainable strategies and further develop their long term operating skills.

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