Private Finance Initiatives (PFI)

Rarely out of the headlines, PFIs attract a wide range of views and emotions from Government, service recipients, providers, trade unions and the general public. Seen on the one hand as a cost effective, efficient way to deliver public services and on the other as inappropriate, being driven by public finance to the detriment of public service.

Learning outcomes.
This CIPS Knowledge Summary is intended to give an overview of PFI, its implications for purchasing and supply management professionals, what the future may hold for PFI and to act as a signpost to further sources of information. It will give the reader:

- An understanding of what PFI is and where it is commonly used as a method of procurement
- An appreciation of the main parts of the PFI process
- An appreciation of the key considerations in delivering a successful PFI and some of the potential pitfalls
- An indication of possible future developments as the PFI market matures

Introduction
Public Private Partnership (PPP) is a means of bringing together the public and private sectors to work together in long-term partnerships to best utilise the assets and skills of both sectors, with the aim of creating better value for money for taxpayers.

There are a number of different forms of PPP of which PFI is one. Other forms of PPP include strategic service delivery partnerships, joint venture companies and arrangements where private sector skills are used to sell public sector services and assets into a wider market. There are inevitably similarities and crossover between different forms of PPP. The key distinction between PFI and other forms of PPP is the use of private sector finance and the length of the contracts involved. PFI is typically used for capital intensive projects.

In comparison with the privatisation of public assets and services PPP is often referred to as being more like a merger than a takeover, with both sides sharing the risks and, hopefully, seeing the benefits.

Background
In traditional major project procurement the public sector raises the capital to finance the build (or infrastructure provision), the private sector bids for a contract to build and once build is complete the facility is handed to the public sector to maintain and run.

PFI is an alternative procurement vehicle by which public sector bodies can provide major capital projects and associated services such as hospitals, schools and roads without raising the capital. In a PFI project, the private sector finances, designs, builds, and operates an asset and associated services. In return the private sector receives an annual payment linked to service performance.

PFI contracts are long term, typically lasting 25 or 30 years. At the end of the contract period the facility generally belongs to the public sector.

Case Study
Case Study – The Portsmouth Highway Management PFI.

PFI is not only used for buildings. In July 2004 Portsmouth City Council entered into the first highways and street scenes PFI.

Portsmouth City Council faced a situation where it needed to make considerable investment into its roads to halt their decline and to make inroads into a considerable backlog of maintenance, whilst recognising that funding for highway maintenance budget was unlikely to keep pace with the declining condition. The Council entered into a 25 year £500m PFI contract with Ensign Highways to manage and maintain all 455km of its roads network. The contractor is responsible for everything "fence to fence" including roads, bridges, street lighting and footbridges.
client. Under PFI the private sector would be responsible for the ongoing maintenance and upkeep of the building and, hence, would be responsible for the cost of maintenance. This contributes to an increased focus on the whole-life cost of the project. The risk of non-performance of the asset will also sit with the private sector as payment mechanisms are linked to performance. The temptation to ‘build cheap, run expensive’ should be negated by PFI.

As a general principle, risk should sit with the party best able to control it. The identification and allocation of risk requires an honest and open dialogue between the parties, as there is a cost attached to risk. An attempt to place risk with the private sector that is not understood and/or cannot reasonably be controlled by the private sector will attract a price loading.

A typical PFI scheme involves the public sector client, the private sector operator, the financial lender, the building contractor and sub contractors, a number of technical, financial and legal advisers, and the facilities management team. To contract for a PFI the private sector establishes a legal company, set up solely for the purpose of the PFI, known as a Special Purpose Vehicle. The SPV is made up of the main contractors and the financers.

HM Treasury state that 90% of PFI capital projects are delivered on time compared with 70% of traditional capital projects being late and over budget. In PFI payment doesn’t start until the facility is operational which gives a huge incentive to the private sector to complete on time.

The raising of finance can be more expensive for the private sector and therefore the other benefits of PFI, for example transfer of risk, anticipated improved performance needs to outweigh this extra cost.

Whatever the other pros and cons of PFI are, there is little doubt that facilities such as schools and hospitals are being built that would otherwise remain in the pipeline waiting for public sector funding.

Key phases of a PFI project

- Option appraisal and project preparation
  - Deciding on the scope of the project
  - Securing business case approval
  - Preparing to go to the market
- Tendering process
  - Inviting bidders to submit and develop tenders
  - Choosing a preferred bidder
  - Negotiating the final agreement
- Construction
- Service delivery

Source: National Audit Office
CIPS positions

- CIPS sees PFI and other forms of PPP as giving practitioners an opportunity to raise their profile. It recommends they are familiar with the mechanisms underpinning PFI.
- Purchasing and supply management professionals should encourage their organisations to involve themselves in PPP projects at the very outset and that they should play an increasingly prominent role as the project progresses.
- Purchasing and supply management professionals should influence their organisations to ensure that analysis is undertaken to ensure that PFI is the appropriate delivery mechanism.
- Purchasing and supply management professionals should assume the role of an intelligent client, for example providing contractors with accurate, full and relevant information in a timely and professional fashion.
- To minimise the risk of incorrect decisions being made, a recognised project management procedure should be employed in all PFI projects.
- Purchasing and supply management professionals should seek to share best practice in PFI procurement.
- Many specialist organisations, Partnerships UK (a private sector body) and 4ps being two examples, have a useful role to play in facilitating public private partnerships.

Impact on purchasing and supply management professionals

PFI offers both opportunity and threat to purchasing and supply management professionals. On the one hand, there is the opportunity to have influence, profile and impact in a key area of public sector expenditure. On the other hand is the potential to be left behind and at best only be involved in the administration of the process.

- To maximise P&SM impact on a PFI procurement it is paramount that early engagement with stakeholders is achieved. Recognition of procurement’s role in the project management and governance structure should be aimed for to establish Procurement’s “right” to input. Influence should start at the option appraisal and project preparation stage when the decision to proceed with a PFI or another form of procurement is made.
- The high value and long-term nature of PFI contracts (typically 35 years) requires increased focus, rigour and application of procurement tools, such as whole life costing, robust governance models, risk management processes, contract change mechanisms, dispute resolution processes, and a shift from input to output specifications. There is evidence that this increased focus is now being applied to general procurement, giving the purchasing and supply management professional, skilled in the application of such techniques, an increased opportunity to raise their profile and impact.
- A recurring theme in PFI contracts is the difficulty that contract managers and others involved in the operational phase have in understanding and interpreting the contract. PFI contracts are by their nature complex and have to cover a wide range of requirements, payment mechanisms and eventualities. It is common for there to be little, if any, crossover between the team who take the PFI to financial close and the team responsible for contract management. This can create unnecessary project delays caused by needless misunderstandings.
- To avoid this situation, the purchasing and supply management professional should seek to ensure that there is sufficient clarity in the contract and that it is written at a level that those involved can understand. It is beneficial, therefore, if there is crossover between the two phases, that the purchasing and supply management professional can make a contribution by assisting the contract management team in ensuring that there is a practical understanding of the contract terms.
- The National Audit Office (NAO) has identified a lack of public sector commercial knowledge in PFI deals, both in the negotiation of the original contract and in the negotiation of contract variations and re-financing deals. It is often said that someone in the public sector is typically working on their first and last PFI, whilst their private sector counterpart will have experience across a number of PFI projects. This criticism is levelled at all the disciplines involved and not purely purchasing and supply management professionals. It does, however, represent an opportunity for the profession to upskill and develop a body of knowledge on PFI. Some local authorities, such as Leeds City Council, have established Public Private Partnership Units to provide advice across all of the authority’s PFI projects, rather than dealing with each PFI in isolation.
- Maintaining bidder interest in PFI is emerging as an issue and there are signs that the number of interested bidders for each PFI project is declining. Declining interest is in part due to the lengthy tendering processes prevalent in PFI (on average 34 months - source NAO) and high bid costs. Since its introduction in January 2006 Competitive Dialogue has become the public procurement procedure most commonly used by the UK public sector. Under Competitive Dialogue more of the PFI deal is developed with a number of bidders before a preferred bidder is selected than was the case in the past maintaining competitive tension. Informal soundings indicate there is a level of resistance from the private sector to Competitive Dialogue and anecdotal evidence suggests that bid costs have increased by up to 50%. It is common for contractors to set an annual budget for how much they are prepared to spend on bidding for PFI projects.
- PFI payment mechanisms are linked to performance measures set against output and outcome specifications. It is crucial that the purchasing and supply management professional involved in PFI has a thorough understanding of defining and applying this type of specification, and of associated performance measures, to ensure that the PFI contract delivers or exceeds the required service requirements.
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• To assist authorities in contracting for PFI projects HM Treasury has produced a standard contract with guidance notes, SOPC 2004, which is available at www.hm-treasury.gov.uk. In addition there are approved sector specific variations such as social care.

Issues:
Given the long-term nature of PFI contracts, typically 25 to 30 years, the effectiveness or otherwise of PFI cannot yet be judged over the full life of the contract. However, there are a number of emerging issues that are of interest to the purchasing and supply management professional.

• As mentioned earlier in this article, the length of PFI tender timescales is highlighted as a key criticism of the PFI process and is showing little sign of reducing. Reasons for delays to PFI tenders that have been identified include: lack of agreement and commitment from stakeholders, variations to the specification and a lack of experience public sector experience in managing complex PFI projects.

• A lack of capacity in the market is an emerging issue. Whilst PFI enables projects to be started that would otherwise be in the funding pipeline, there is a possibility of flooding the market with projects without a corresponding increase in market capacity. At the present time in 2007, there is a high demand for construction capacity in the UK brought about largely by the build programme for the London 2012 Olympics, which is not funded through PFI. Contractors and funders will assess the relative attractiveness of PFI v. traditional projects funded by the public sector.

• Refinancing is a high-profile issue. As the PFI market has become more established, there is potential for improving the financing of a PFI. This is because the financial risk in a successful PFI decreases as it goes through the service delivery phase. Additionally, the PFI market is becoming increasingly mature and viewed as lower risk than when many PFIs were originally financed. However, there have been concerns that the public sector has not always received its fair share of the benefits from refinancing. For example, the Norfolk and Norwich PFI project was refinanced, leading to an increased investor rate of return from 16% to 60.6%, whilst the authority had a £3.9m gain. This was accompanied by a £6.257.3m increase in the authority’s maximum liability should it wish to terminate the deal early. (source NAO). All PFI contracts since July 2002 should include provision for the authority to receive 50% of any gains arising from refinancing. Contracts signed prior to this date that do not have specific provision to share gains are covered by a voluntary code under which the authority would generally expect to receive 30% of any gains.

• As PFIs are increasingly funded through complex financial packages, they are vulnerable to mergers, acquisitions, rising and falling financial markets, bankruptcy and changing corporate objectives. Changing partners may lead to relationship issues and questions around the commitment of new parties to the original aims and objectives of the project.

On the books
It is sometimes stated, incorrectly, that one of the key factors that makes PFI attractive to the public sector is that it is not written down on the balance sheet. However, around 50% to 60% of projects by capital value are reported on departmental balance sheets. The way that PFIs are accounted for is complex and will vary from PFI to PFI. However, the key test is to look at where the costs sit by examining who effectively owns the asset and the majority of the risk. Since 2006 the future debt liability of PFIs recorded on departmental balance sheets has to be recorded in public sector net debt estimates. This means that more of the future costs of PFI projects will be recorded in the government balance sheet.

Hints and tips
• Do refer to the wide body of PFI information available from organisations, such as 4ps, and the other organisations referred to at the end of this Knowledge Summary
• Do share best practice with others involved in PFI
• Do maintain some continuity of personnel between the different phases of the PFI
• Do retain personnel with PFI experience to work on other PFI projects

PFI future
PFI is firmly established as a method of procurement for capital projects in the UK and is becoming increasingly used in other parts of the world. It is estimated that PFI will account for 10-15% of gross public investment over the next few years. The bid cost and timescales involved in the PFI procurement phase is an issue and this may adversely effect the attractiveness of PFIs to the private sector. As PFI becomes more widely used in markets outside of the UK, the UK public sector may need to review its own approach to ensure that the UK PFI market remains attractive to contractors and investors.

Expected growth areas for PFI in the UK are Waste, Estate Rationalisation and Regeneration (source Partnerships UK).

The highly publicised failings of a number of PFIs, such as the Metronet PFI for the upgrading of significant parts of the London Underground network in 2007, may have dented confidence; this has certainly led to an increased awareness that PFI may not be appropriate for all large scale projects, especially the more complex.
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Over time it is likely that the nature of PFIs and other forms of Public Private Partnerships (PPP) will evolve and the model will be refined to mitigate some of the identified shortcomings. For example, some public sector bodies are exploring the use of best practice procurement tools that have become embedded in PFI, such as whole life costing of assets, and applying them in PPP models in which the Public Sector raises the finance at the more competitive rates that it can attract compared with the private sector.

Another emerging trend, aimed at providing overall better value for money, is the bundling of a number of smaller schemes into a single, large project.

Conclusions
PFI and other forms of PPP will remain an important procurement vehicle for the public sector in delivering services to the public. There is an opportunity for P&SM professionals to play a key role in the delivery of PFI. However, there is a need to ensure, along with other professionals in the public sector, that skills and knowledge are developed, retained and shared.

What the long-term legacy of PFI will be is open to debate and will only become clear as the current crop of PFIs reach maturity in 20 to 30 years.

Further information
CIPS:
“Beyond Project Management” a CIPS Knowledge HowTo complements this PFI Knowledge Summary and is a guide to planning, letting and managing complex ICT/PFI and PPP programmes. Available to download from the CIPS website www.cips.org

National Audit Office publications:
A full list of NAO publications on PFI can be found at www.nao.org.uk. They include:
“Improving the PFI tendering process”.
“A Framework for evaluating the implementation of Private Finance Initiative projects volumes 1 and 2”.
“Managing the relationship to secure a successful partnership in PFI projects”
“Update on PFI debt refinancing and the PFI equity market”
“Getting value from Private Finance”

4ps:
A full list of 4ps publications and guidance can be found at www.4ps.gov.uk. They include:
“A guide to contract management for PFI and PPP projects”

HM Treasury publications:
A full list of HM Treasury publications on PFI can be found at www.hm-treasury.gov.uk/documents/public_private_partnerships

Partnerships UK
A joint venture between the public and private sectors which provides assistance and guidance to the public sector on PPPs. www.partnershipsuk.org.uk