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Private Finance Initiative – a good deal for the public purse or a drain on future generations?

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English

The Private Finance Initiative (PFI), introduced by the Conservatives in 1992, has been enthusiastically embraced by the Labour government, with projects worth £12 billion (capital cost) signed between 1997 and 2000. The charge to the public sector includes the capital cost and a charge for the service, with the resulting 'unitary payment' charged over the life of the contract which may extend beyond 20 years. PFI is thought to have advantages over traditional procurement, including risk transfer, innovation and value for money. This article explores these advantages in some depth and concludes that the advantages of PFI may not be as significant as some proponents suggest.

Français

L'initiative Financière Privée 'Private Finance Initiative' (PFI), introduite par le parti Conservateur en 1992, a été adoptée avec enthousiasme par le parti travailliste, avec des contrats s'élevant à 12 billions de Livres (coûts d'investissement) signés entre 1997 et 2000. Les frais pour le secteur public incluent les coûts d'investissement et des frais pour le service, avec pour conséquence un 'paiement unitaire' devant être payé pendant toute la durée du contrat qui peut se prolonger au-delà de 20 ans. On pense que la 'PFI' est avantageuse par rapport à l'acquisition traditionnelle, y compris le transfert de risque, l'innovation et le rapport qualité/prix. Cet article étudie ces avantages en profondeur et conclut que les avantages de la PFI ne sont peut-être pas aussi significatifs que certains partisans le suggèrent.

Español

La Iniciativa de Finanzas Privadas (PFI) que fue introducida por el partido Conservador en 1992, ha sido bien aceptada por el gobierno Laborista con proyectos firmados entre el año 1997 y el año 2000 de hasta un valor de 12 billones de libras esterlinas (precio capital). El coste al sector público incluye un precio capital y un coste por el servicio, con el resultado de un coste de 'pago unitario' sobre la duración del contrato, el cuál se puede extender por más de 20 años. Se piensa que la PFI puede tener ventajas sobre la tradicional ganancia incluyendo el riego de traspaso, la innovación y la relación calidad-precio. Este artículo explora estas ventajas en poca profundidad y concluye que las ventajas de la PFI no son tan significantes como algunos proponentes sugieren.

Key words: Private Finance Initiative • value for money • innovation • risk

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Introduction

According to Terry (1996), the origin of the Private Finance Initiative lies in a fundamental belief by the former Conservative government that tighter control of public expenditure is necessary to control inflation. A further motivation was its belief in the ability of the private sector to deliver better value for money (HM Treasury, 1995).

Although essentially a Conservative initiative, PFI has been embraced by the Labour government albeit following some changes as a result of the findings of the Bates Reviews. These changes were not aimed at changing the nature of PFI, but rather at improving the process and increasing the speed with which projects reach contract signature. The PFI is now seen as an essential item of the government's Public Private Partnership toolkit, and will be important in delivering objectives in a number of policy areas. In Scotland, for example, in its 'Programme for Government', the Scottish Executive has undertaken to build or substantially refurbish 100 Scottish schools by 2003. As at mid-2000, PFI was being used to build or refurbish around 80 schools, at a total capital cost of £500m. At the UK level 150 projects have been signed since May 1997, at a capital cost of £12 billion, with projects worth an additional £20 billion expected over the next three years (HM Treasury, 2000). These projects include hospital projects, schools, prisons, defence contracts and modernisation of the government estate. PFI has also been used to provide IT systems, for example to the Passports Office, the Benefits Agency and the Immigration Service, and to build major roads and bridges (eg the Skye Bridge).

The capital cost figures quoted above indicate that the PFI is now clearly a major player in infrastructure provision. However, the capital cost is only part of the total cost of a PFI project. In any project, the public sector client pays a unitary charge in return for services over the contract life (usually lasting 20 years or more). This charge covers both the capital costs involved and the revenue costs associated with providing the service, and the financing costs of the project[1]. Because of the implications of contracts signed today for the Public Sector Borrowing Requirement (PSBR) and revenue budgets in future years, the government has undertaken to inform Parliament of PFI commitments on a regular basis. This is important given that PFI financial commitments are ring-fenced within departmental budgets. Clearly then, there are concerns about possible financial burdens placed on future generations by this initiative – thus the question posed in this article.

We begin with a summary of the background to the introduction of the PFI and the issues raised by it, going on to discuss briefly the research on which this article is based. The central issues of additionality, value for money, and risk transfer are then explored in some detail, with the conclusion returning to the question of whether the PFI does indeed represent a good deal for the public purse or a financial burden for future generations.

Background

Prior to the development of the PFI, private sector investment in the public sector was determined by the so-called Ryrie rules. Under those rules, decisions to provide funding for investment had to be taken on the basis of fair competition with private sector borrowing. Furthermore, no account could be taken of the lower level of risk associated with government projects. The Ryrie rules were originally developed for the nationalised industries but were taken to be a statement of the Treasury's position on the use of private finance in general in the public sector. They were regarded as a huge stumbling block to greater private sector involvement in infrastructure and were retired by John Major in 1989. This paved the way for the announcement of the Private Finance Initiative in 1992. The PFI differs from conventional capital projects in three significant ways. These are summarised below:

1. The private sector organisation involved not only constructs the capital asset but is also responsible for its continuing operation and maintenance. Effectively, therefore, the public sector rents a facility rather than owns an asset.
2. An output specification is used in which public sector clients specify their requirements in terms of the services required. (Thus, procurement for a prison becomes that for custodial

services, and a road, procurement for highway services.) It will be up to the private sector bidder to come up with a design that meets the public sector client's requirements (HM Treasury, 1996a).

3. Some of the risk associated with the project must be transferred to the private sector. Otherwise the project will still be classified as a public sector one and count against the Public Sector Net Cash Requirement (PSNCR – formerly known as the PSBR, which, for ease of reference, we will use in the remainder of this article).

> Insufficient risk transfer will not only undermine value for money savings but place the asset on the public sector's balance sheet. (HM Treasury, 1996b: 1)

There are a number of issues to consider in deciding whether the PFI is indeed a good deal for the public purse. Perhaps the most important are:

- ***Additionality***: does the use of the PFI allow a higher level of capital investment, ie is it additional to the level of traditional infrastructure procurement?
- Does the use of the PFI allow better ***value for money (vfm)***, enabling the public sector to deliver more with currently available levels of finance, than would otherwise be possible?
- Since ***risk transfer*** appears to be crucial in the vfm test, can risk be efficiently transferred to the private sector and, if so, how?

The research

This article is based on the findings of a research project, funded by the Leverhulme Trust, to look at the managerial and economic implications of the PFI. Through economic modelling, we have sought to determine the medium- and long-term impact on the national economy of the adopted and expanded use of PFI. The results are discussed briefly below (further details of this part of the research can be found in Ball et al, 2000a). The research also involves the in-depth study of a number of actual PFI projects using a range of methods including case study and participant observation. We seek to determine whether PFI does in fact result in cost-effective, innovative design, and operating and maintenance cost savings. We also look at which risks are actually shifted from the public to private sectors in practice, and whether the cost implications of such risks can be identified.

The first of the major studies is now completed and some key findings are used here to support our arguments. The subject of the study is a Local Authority PFI project to replace a secondary school.

Additionality

In the early stage of PFI development, the Treasury implied that PFI could allow additional investment above that possible if public finances alone had been used. While this may not seem a contentious point, it is still clearly an area of confusion for government ministers. Alan Milburn made reference to this macro-fiscal argument in his speech launching the Commission on Public Private Partnerships, despite the fact the Treasury had more latterly been playing down the importance of this argument (Robinson, 2000). Indeed, Robinson has demonstrated the fallacy in this argument, showing that, even under the current fiscal stance, the Treasury could easily have financed all of the PFI projects signed to date, using conventional methods. Indeed, this could have been done without breaching either the Treasury's 'sustainable investment rule' or the 'golden rule'[2].

There are at least three ways in which the PFI could lead to *additional* public investment:

1. if it could access new sources of finance;
2. if its use was to result in overcoming a constraint on public expenditure such as the PSBR;
3. if PFI projects could be shown to be significantly more economical than public sector ones (each capital project costing less under PFI), thus resulting in a higher volume of investment for a given level of finance.

We shall now examine the first two of these possibilities, with value for money issues (item 3) considered later in this article.

Accessing new sources of funding

A number of commentators have erroneously suggested that the PFI can tap sources of finance not normally available to the public sector. These include the then Chancellor Kenneth Clarke (1995) who stated that: "The PFI is unlocking new resources and will increasingly replace old-style public sector capital spending, delivering far more on the ground than what went before it" (Clarke, 1995: 4). The Treasury, however, point out that both private and public sector projects tap virtually the same pool of resources:

> The well developed system of capital markets in the UK with its access to global markets, means that a wide range of funds is available to both government and to private promoters to finance UK based projects. It is possible that private promoters may be able to tap some funds which would not normally be used for gilts. But no measurable differences in macroeconomic effects are likely to follow. (Treasury, 1993: 13)

There has long been a worry that public sector projects might 'crowd out' private sector ones. By itself, however, a move to financing by PFI is unlikely to have much effect on this. According to Heald (1997: 570): "Private investment is just as likely to be crowded out by privately financed public projects as by publicly financed public projects".

Overcoming the PSBR constraint

Traditional public sector investment must be funded 'upfront' and as a result has the effect of increasing the PSBR. With PFI, since the asset is funded and owned by the private sector, it *appears* that the investment can be provided without affecting the PSBR, even though the present value of the financial commitment by the government may be very similar, whether the public sector owns the asset or not (Grout, 1997).

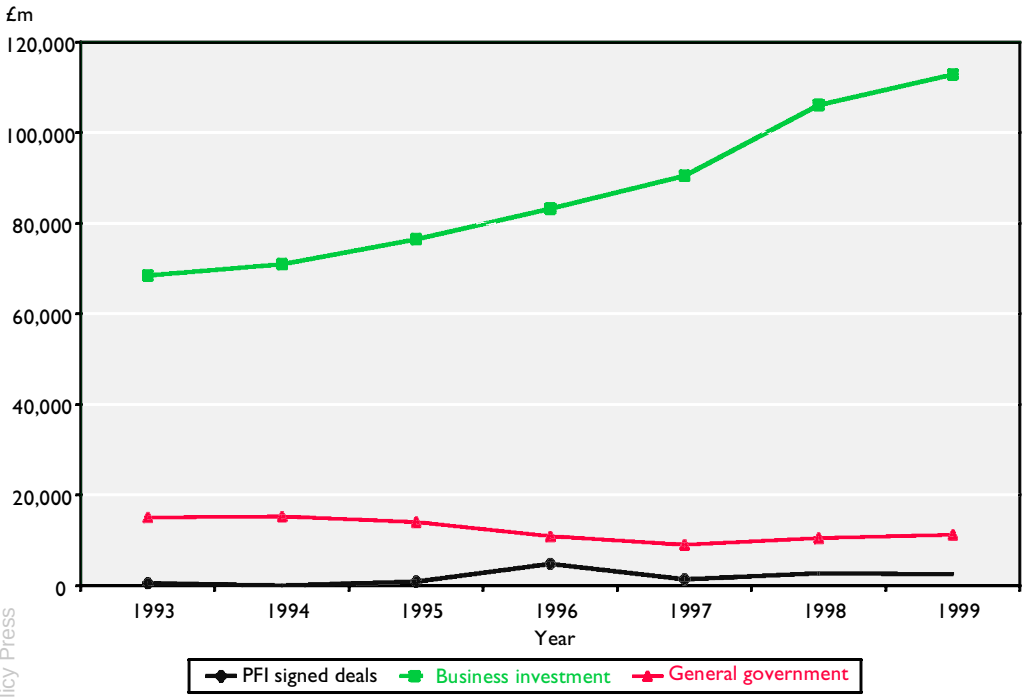
Thus with PFI, providing that an appropriate level of risk is transferred, the project will not appear on the public sector's balance sheet and will not *immediately* count against PSBR. The government's commitment to the Maastricht Treaty limits PSBR to 3% of GDP. Despite the findings of Robinson (2000) (that the PSBR constraint would have been unaffected if total PFI investment to date had instead been financed using traditional methods), this has been one of the supporting arguments for the PFI. However, as the capital in a PFI project is repaid it *does* count against PSBR (unlike conventional public sector projects, where the 'hit' on the PSBR occurs immediately the investment is undertaken). Thus, it is highly likely that the use of PFI will tend to *defer* the effect on PSBR, placing the financial burden onto future generations. We have attempted to model this and our results are given in detail in Ball et al (2000a). Results show that when some spending is transferred every year from traditional finance to PFI finance, public sector borrowing will fall for many years, but may not fall permanently. Further, the required tax yield may be permanently higher or permanently lower. Finally, even if a switch to PFI did reduce both the PSBR and taxes, it might not facilitate much extra investment for the public sector. Thus, the impact of the PFI on the PSBR and the public finances is less straightforward than it would at first appear and is less than proven.

The volume of investment

The final question to ask with regard to additionality is whether there is any evidence to indicate that the introduction of PFI facilitates additional investment in the economy. One obvious approach is to look at the trends in investment and capital expenditure resulting from PFI. . Figure 1 is based on information from *Economic Trends*, May 2000**.** It shows a picture of declining general government investment and fluctuating PFI expenditure (the 1996 'blip' is due to the Channel Tunnel Rail Link project, costing £3000m). Such a pattern of expenditure would be consistent with PFI not providing any net additional expenditure. Business investment (which refers to the private sector and excludes dwellings, but includes public corporations except NHS Trusts) has increased steadily from 1994 onwards although, as we can see, PFI seems to have made little contribution to this.

Hall (1998) also explored the question of additionality. His analysis involved monitoring the

Figure 1: Investment trends in the public and private sectors



Source: *Economic Trends* May 2000

Note: The figure illustrates trends in Gross Fixed Capital Formation. Business investment refers to the private sector but includes public corporations except NHS Trusts. The figures exclude dwellings and the costs associated with transfer of ownership of non-produced assets.

change in planned public expenditure for 1997/98. This projection had been cut three times since November 1994, by £2bn in November 1995 (a 9% cut), by £1.8bn in November 1996 (a 9% cut) and by £1bn in March 1997 (a 5.5% cut). He concludes that this evidence "Suggests that the private finance initiative has been used as a substitute for, rather than an addition to public sector investment" (Hall, 1998: 215)

The answer to question (3), posed earlier, also involves exploring the value for money (vfm) arguments for PFI. This is done in the following section.

Value for money and the PFI

At a superficial level, there are a number of reasons for believing that, all things being equal, a PFI project may be more expensive than a conventional one. These are discussed below.

The costs and forms of financing

The first concerns the cost of borrowing. There is general agreement that the public sector, due to its size and consequent ability to bear risks together with its tax-raising powers, can borrow more cheaply than the private sector. Thus the private sector will face higher interest rates when borrowing to finance a PFI project. A consultants' report commissioned by the Treasury Taskforce (Treasury Taskforce Private Finance, 2000) considered this issue and concluded that, although private finance may represent an additional cost, it is not such a significant cost that value for money is inherently likely to be imperilled, provided the private sector is able to deliver savings in other aspects. It identifies the current weighted average cost of private sector capital on PFI projects as between one to three percentage points higher than public sector borrowing.

While this appears a narrow margin, however, it represents a substantial amount of money over the life of a contract of 25 to 30 years or more.

The way in which the projects are funded can also have an impact on costs of financing. PFI projects are usually part funded through equity (with a required rate of return for shareholders), with the usual split being 90% debt and 10% equity, although this can vary. There is a view that such high levels of debt are undesirable in a PFI project and that the optimum level of equity finance stands some way above the 10–15% level (Scottish Office PFU, 1996). Despite this view, expressed by the Scottish Office, our findings suggests that equity funding in PFI projects is declining, with a number of projects in Scotland now almost entirely debt funded (see Ball et al, 2000b). Such funding structures have implications for risk distribution, with the public sector taking on more risk, compared to the traditional PFI structure, in order to satisfy the financing partner involved in the deal. The advantage of this structure, however, is the lower cost of finance – equity funding can be expensive. Projected real rates of return to PFI equity holders can be high. For example, the rates of return to equity holders for the Fazakerley and Bridgend prisons respectively were 12.8% and 19.4%, (Hall, 1998), and those for the Skye bridge were substantially in excess of 12% (National Audit Office, 1997a). Even where equity forms a small part of the overall financial package, the returns can still be high. The rate of return for the high school PFI project we have been researching (with equity at 1%) will be in excess of 30%. Under the conventional 90:10 split (debt to equity) the return was originally predicted to be around 16%.

The bidding process

In addition to the costs and forms of financing, there are additional reasons why PFI might be more expensive. In particular, the bidding process is undoubtedly more expensive under PFI than with traditional methods for both public and private sector partners. The public sector usually has to make extensive use of external consultants for legal, technical and financial advice. The private sector may also have to make use of such consultants, although they are more likely to have the expertise in-house. The bidding process itself is longer and more complex, although the Taskforce[3] hope that 'pathfinder' projects will lead to the development of standard contract documentation which can at least reduce the legal costs, even though these will have no impact on design or architectural costs.

The bidding process starts with an advertisement in the Official Journal of the European Community (OJEC). This is followed by publication of a Pre-qualification Document, to which interested bidders respond and from which usually three bidders are shortlisted for the next stage. The bidders then respond to an Invitation to Negotiate (ITN), and a preferred bidder is selected, with a second bidder held in reserve. There then follows an intensive period of negotiation between the preferred bidder and the public sector client, as the service contract and payment mechanism are finalised. This whole process can last 18 months or longer, with adviser fees being particularly hefty as the implications of potential solutions for cost and affordability are analysed. In the high school project we have been following, the length of the negotiation period has been substantially reduced, as a result of the experience gained from other such projects. The role of external advisers in building up this experience from project to project appears crucial.

The National Audit Office (1997b) estimates that the cost of the bidding process under PFI can be in the region of £0.5 million to £2.5 million. Others estimate that the bidding costs to the private sector under PFI are seven times higher than under conventional tendering, with total costs for all bidders reaching 3% of total project costs in some cases (Stewart and Butler, 1996). Still others claim that £250,000 is a 'rock bottom entry price' (McIntosh, 1995). In the high school project (and in other projects with which we are familiar) there is evidence to suggest that some private sector operators are having problems resourcing their bid, and consequently their ability to do this is becoming a key criterion in the selection of shortlisted bidders[4]. Local authority projects tend to be smaller than projects in, say, highways or health and consequently bidding costs can form a substantial element. Evidence from the high school project indicates that the cost of the bidding process to the local

authority stands in the region of £500,000. Excluding the costs to the private sector, this alone takes bidding costs to more than 3% of the capital cost of the project. This is one reason why local authorities are being encouraged to bundle together such projects (where more than one school requires new build or refurbishment). The implications of these high bidding costs are then that PFI is only suitable for relatively large capital projects (£10 million minimum) and that only three bidders should be shortlisted to ensure that chances of being selected as preferred bidder are attractive enough to the private sector.

To summarise, these higher bidding costs could make PFI projects more expensive vis-à-vis traditional projects. If a company achieves preferred bidder status and reaches financial closure, these bidding costs are recouped and are seen as part of the charge to the client. Failed bids represent a loss to the private sector bidder, which may have to be borne by other more successful parts of the company in the short term. In the medium to long term a series of failed bids will lead to exit from the PFI market place. There is the option to recoup failed bid costs from future successful bids but competition between bidders may prevent this from happening. In the Public Sector Comparator (PSC), where the cost of undertaking the project using PFI or traditional procurement is compared, the bidding costs of the public sector can be included in the calculation (although the private sector costs will not be).

The importance of innovation

The higher costs of both the bidding process and financing a PFI project may be balanced or outweighed by additional benefits.

> Private finance may, therefore, represent an additional cost, but it is not such a significant cost that value for money is inherently likely to be imperilled, provided the private sector is able to deliver savings in other aspects of the project. (Treasury Taskforce Private Finance, 2000: para 2.12)

Thus, supporters of PFI would argue that the higher costs of finance and of the bidding process are outweighed by the potential benefits inherent in the PFI. One of the major benefits of PFI is seen to be the opportunity for innovation in terms of funding packages, delivery of services, and construction of the asset.

Innovation can lead to savings in terms of both construction costs and operational costs. With a PFI project, the public sector client produces an Output Specification to which the private sector responds (this is the Invitation to Negotiate document mentioned earlier). The clients, theoretically, do not state the type of asset they require. Rather they state the type of service they require, or the service needs they require to be met. For example, in hospital PFIs the health trust does not state the number of beds required but instead states the expected level of clinical activity required to be serviced. The private sector bidders then decide the best way in which to meet this need. The received wisdom dictates that this process allows for innovation in terms of the design, of the asset, and in the way in which the asset is operated. For example, operational costs savings could be achieved by the installation of a particularly efficient heating system and the use of energy efficient materials in construction and design. The installation of a high-tech security system could reduce vandalism. As the private sector owns the asset and provides a service, it will be economically advantageous for it to make the operation of the building as efficient as possible, thereby increasing profit margins.

In the high school project we have been following, there has been little evidence of innovation in design, with the only innovative features directed by the public sector and detailed in the original brief as a requirement of the authority. This finding is supported by evidence from a further hospital project, where the seemingly innovative design of a new PFI hospital appears to be based on another recently completed hospital, built under traditional procurement, with the same architect employed on both projects. In the high school project we found that the private sector were advised, prior to bid submission, of the acceptability or otherwise of particular design solutions through informal technical meetings with the local authority. This was unexpected given the intended 'output specification' approach of PFI and seems to be indicative of a movement away from an output specification, to an input specification approach

(see Ball et al, 2000c). Despite the lack of design innovation, however, there was clear evidence of financial innovation on the part of one bidder, in an attempt to make their bid more competitive (discussed earlier under 'Costs and forms of financing').

There is the further possibility that operational costs will be reduced through other means – for example, lower staff costs achieved through reductions in staff numbers or employment conditions. Most PFI projects involve the transfer of staff from the public sector to the private sector – usually staff responsible for maintenance, catering, cleaning, security etc. Staff transfers are covered by TUPE[5], whereby staff receive a guarantee of continuation of current employment conditions for at least one year after the transfer. In the case of the high school project, the TUPE arrangements last for five years, but the local authority will indirectly pay for these enhanced terms through the charges set by the appointed consortia. Thus any impact on employment conditions is unlikely to occur immediately, but may do so in the short to medium term. This is obviously an area for future research.

Evident in much of the early literature on the PFI is a strong belief that the private sector is inherently more efficient than the public sector. For example, it is claimed that, under PFI, because the private sector will be financially penalised for cost and time over-runs, there will be fewer instances of public sector projects costing much more than originally estimated and being delivered years late. As with traditional procurement, however, under PFI the private sector will only be penalised in such circumstances if delays in delivery and cost over-runs are their fault. If delays are due to the public sector changing the brief once the contract is signed, then the private sector cannot be penalised. In this respect the PFI differs little from traditional procurement. What may be different is the way in which the PFI will discourage the public sector from making changes, because of the potential costs involved. Additions and changes will not be costed in the normal way (where detailed information is available on rates and costings), but will be negotiated. Further, the private sector will be in something of a monopoly position, given that they own the building and usually hold the long-term lease of the site.

The role of the public sector comparator

Value for money is usually determined by the development of a Public Sector Comparator (PSC). However, in the early stages of PFI development, if there was no prospect of the project being publicly funded in the near future, a PSC was not developed. For example, the National Audit Office in its report on the Skye Bridge project states that: "In 1990 the Department had ruled out preparing a public sector comparator based on comparison with a publicly funded bridge" (National Audit Office, 1997a: 43). They concluded that this would be false and misleading since they had no intention of funding the Skye Bridge except as a privately financed project. This report goes on to state: "Value for money under private finance depends on the balance between the benefits obtained from a project and the price paid for them" (National Audit Office, 1997a: 43).

Nevertheless, the lack of a public sector comparator does remove an important dimension of value for money. A PSC is now always prepared in the development of a PFI project, whether public funding is an option or not. In the case of the high school project, the authority is quite clear that PFI is the only option if it is to procure a new high school. Many local authorities currently developing PFI projects in Scotland will be in the same position, given the size of their Section 94 capital allocation[6] and the cost of procuring a new school. This lack of alternatives raises the question of how objective local authorities might be in the compilation of their Full Business Case (FBC) for a PFI project, of which the PSC forms an integral part. The latest analysis of value for money in the PFI commissioned by the Treasury Taskforce concludes that vfm may well be achieved in PFI projects: "…provided the private sector is able to deliver savings in other aspects of the project. The business cases we have examined suggest these savings are deliverable" (Treasury Taskforce Private Finance, 2000: para 2.12). An important point to add, however, is that, at the time of putting the PSC and the FBC together, many of these savings are estimates, and the report also notes that:

> The long term value for money of PFI projects will depend on how well the pri-

> vate sector manages the risks transferred to it and on the public sector's success in managing the contracts over their duration, a significant proportion of which are for 25 to 30 years. (Treasury Taskforce Private Finance, 2000: para.2.12)

We suggest later in this article that the level of risk actually transferred to the private sector is less than would have been expected. However, it could be that some private sector operators may take on too much risk and consequently may default on the contract, with implications for value for money (although the funding partners in any consortium are unlikely to allow this to happen). More likely perhaps is the instance where the public authority may be unwilling or unable to enforce fully the contract and the penalty system in the event of service failures. Such instances may be envisaged where the interests of partnership in the longer term predominate, or where the service specification is insufficiently detailed to enable penalties to be applied fully in the event of service failures (see Ball et al, 2000c).

In other cases the public sector comparator can be very sensitive to the assumptions on which it is based. The Private Finance Panel, looking at the PFI for Bridgend and Fazakerly prisons, concluded that:

> the economic appraisal indicated a minimum 10% saving for the new DCMF [Design, Construct, Manage and Finance] prisons over a 25 year operational period against a comparison with a realistic public sector comparator. (Private Finance Panel, 1996: 15)

Little information on data or methodology is provided. , although this of course does not invalidate this finding. However, a review of the literature on the construction of PSCs published by the Treasury Taskforce shows that the exercise itself is less than clear cut and transparent:

> The principal evidence that value for money has been achieved is normally provided through the use of a comparator. However sophisticated the comparator is, it is important to remember that this process inevitably focuses on the factors which can be easily quantified and expressed in monetary terms. Other factors, notably risk transfer, service quality and wider policy objectives are less easy to quantify and may not be fully reflected in the comparator…. It follows then that a PSC which is lower than a PFI bid should not always imply automatic rejection of the PFI bid. Consideration of the wider benefits (and costs) of accepting a PFI bid may lead an accounting officer to conclude that PFI still represents best value for money; eg because of the transfer of risks which are not quantifiable and hence not reflected in the PSC. (Treasury Taskforce, 1998: 5,6).

These observations apply to the high school project we have been researching. In this particular case, however, value for money and affordability was helped by the inclusion of the former school site in the deal, for which the private sector consortium were prepared to pay £1.1m. Many PFI projects include such land deals.

The way in which PFI may be driving other efficiencies in the public sector

The issue of value for money and PFI can also be considered in a wider context, and this is the way in which PFI appears to be driving other efficiencies in the public sector. We are unsure at this stage whether such changes are coming about as a result of the costs of PFI and the need to find savings elsewhere, or are the result of the introduction of a wider private sector ethos into the public sector. For example, in our research, the new PFI school will be used as a benchmark for other schools in a local authority area, in terms of facilities management. The way in which public services are being delivered is also changing. For example, in one of the hospital projects we have looked at, the role of the nurse will change in the new hospital, with fewer housekeeping duties to do (these will be undertaken by a new level of staff below the nurse, known as the 'ward hostess') and more duties taken over from the doctors (for example more nurse-led clinics). Pre-admission clinics will also be much more common to reduce the length of stay in hospital,

as the economics of the new PFI hospitals will require a much higher patient throughput than was previously the case (see Pollock et al, 1997).

In the local authority sector, rationalisation of the school stock is usually one of the outcomes of a PFI schools project. It may be that the economics of a PFI project require the authority to make savings by amalgamating schools. PFI is driving service changes in this sector too. For example, local authorities usually make school facilities available for use by community groups through a community letting system. In PFI projects, these facilities will be used to generate a third party income. In one of the authorities we have looked at, letting procedures will have to be substantially changed so that, whereas previously lets would be long-term in nature and a single let would involve eight different personnel steps to set up, post-PFI there will be a single point of contact. This was required in order to speed up the process and enable the private sector to operate the premises more efficiently.

Transfer of risk

Transfer of risk is a key element of PFI and is closely related to the value for money issue. As noted earlier, unless there is significant transfer of risk to the private sector, the asset appears on the public sector balance sheet and so has an immediate impact on PSBR. The decision about whether sufficient risk transfer has taken place is made by external auditors and is ratified by the Scottish Executive or the Treasury, whichever is appropriate.

The valuation of risk is central to the value for money calculations of the PSC. The Arthur Anderson Report (prepared for the Treasury Taskforce, 2000) estimates that savings of an average of 17% have been achieved in the range of PFI projects they studied. Excluding IT projects, where there have been particular problems, this margin reduces to 10%. However, there are a number of cautionary notes to add to this finding. First, despite the centrality of risk valuation in the vfm calculation, more than 40% of the projects analysed in the study did not include a risk transfer valuation in the FBC. Second, of the 17 cases which did include a risk transfer valuation, 35% depend entirely on risk transfer to achieve vfm. Given the uncertain nature of risk valuation and risk transfer, a retrospective (or longitudinal) study of whether these projects do actually achieve vfm would be useful.

From the inception of PFI, the private sector has been reluctant to take on risk for a number of reasons. One reason is undoubtedly the cautious nature of parts of the British banking system, which is not accustomed to providing long-term funding. The financial partners in the PFI consortium have been described as the 'secret project managers' because, at the end of the day, a project will only go ahead if it has financial backing. The banks will be cautious about the level of risk the consortia should take on and will seek to reduce the level of risk wherever possible. There are various different types of risk involved in any particular project. The general rationale behind the distribution of risk among the various partners is that risks should be taken on by those most able to control them. (CBI, 1996).

One way of reducing the risk in a PFI project is to build an asset which has an alternative use should the intended use fall through, for whatever reason. For example, a further education centre PFI which we have studied is designed to be converted into offices, should this be required. It is said that problems in concluding the Inverness Airport project were related to the fact that there could be no alternative use for such an asset.

Another area of risk where the private sector has sought to reduce its exposure is that of volume risk (demand for their facilities). With the prisons PFI, for example, the private sector consortia were unwilling to take the risk that the facility might be unoccupied because of changes in sentencing policies. Thus the contract and payment mechanism is based on cell availability as well as a number of other service indicators. Our experience of PFI projects (we have detailed information on three separate projects currently) and a further review of official reports on major infrastructure projects indicates that most contracts are based on availability of a facility, rather than occupancy. For example, in the high school project quoted earlier, the private sector are unwilling to take on the risk of a falling school roll. Determined by population parameters, this is seen as something over which they have no control. However, the size of the school roll may also be affected by the quality

of the facilities as well as the quality of the teaching. . In a water purification scheme we are looking at, the private sector operator was willing to take on the risk of a wet year and a dry year, but unwilling to take the risk that one of the industrialists, which contributes most of the pollution and consequently provides a significant share of revenue, might go out of business. There is also general reluctance to take on the risk of legislative change.

Due to the private sector's unwillingness to take on risk, the government has introduced a number of concessions which effectively reduce the amount of risk faced by the private sector. The 1997 NHS (Private Finance) Act and the 1996 NHS (Residual Liabilities) Act together give the private sector the guarantee that the public sector is tied into PFI payments even in the event of a health trust bankruptcy. For prison PFIs, the government has become the insurer of last resort if, through no fault of the contractor, insurance becomes unobtainable, perhaps due to prison riots etc, and in the case of the Skye Bridge, the government has given a guaranteed price rise to the contractor should the volume of traffic be less than expected (Unison, 1997).

The question arises as to how risk distribution differs under PFI from that of traditional procurement. As mentioned earlier, the project cannot be counted as a PFI, unless sufficient risk is borne by the private sector, so that the asset appears on the private rather than the public sector balance sheet. Table 1 illustrates the risk distribution that was envisaged at the start of the high school project which we have been researching. In the event, risk transfer turned out to be significantly less than planned.

Clearly one of the most important risks taken on by the private sector was that of availability of school buildings. This risk is reflected in a series of penalties which will apply in the event of a failure of services provided by the private sector. During the negotiation phase, the private sector applied continuous pressure and incentives were offered to dilute the penalty regime. In the end, the penalties were based on a zonal system. For an area designated for 'school use' this was 1/160 of the annual fee for that area. For an area designated non-school use it was 1/300 of the yearly fee. If more than 33% of the school becomes unavailable at any one time (for example through a breakdown in the heating system), the whole school would be declared unavailable. Penalties can also be levied for space designated as 'unavailable but used'. These penalties would apply if a room did not meet the

Table 1: Proposed risk allocation in the high school project

Risk area	Council and private sector share*	Private sector
Design and build (construction risks)	Planning Transitional costs Decanting Disruption Statutory regulations Council changes to design	Ground conditions Environmental Construction costs Public utilities costs Design adequacy
Operational	Inflation	Delay in commencement Level of operational costs Level of maintenance costs Ongoing defects Availability Security Staffing
External	Impact of volume on running costs Third party revenue streams Obsolescence risks	Residual value Lack of funding Costs of funding (changes in interest rates)

*The actual share of the risk taken on by public and private sectors will be decided in negotiations.

standards laid down, but was nevertheless used to avoid disruption to the curriculum. Such a potential penalty is essential if the operator is to be deterred from continuously operating in a sub-standard fashion, without adverse consequence. During negotiations, particular pressure was applied to reduce this penalty and concessions were made, with the penalty reduced from 75% of the daily rate to 25%.

It was originally envisaged that the private sector consortium would take the residual value risk (ie the risk associated with the value of the building at the end of the project). Changes in PFI policy which occurred during project set up allowed the council to negotiate the acquisition of the building at the end of the contract. In many ways this is a good deal for the council given that it was felt to be inevitable that the contractors would try to recover their capital costs during the initial contract period and that the risks to the council in negotiating a future contract period are eliminated. The downside, however, is that this process does transfer the residual value risk to the public sector. Also the incentive of maintaining the asset to a high standard given the possibility of negotiating a second contract period with the client no longer exists. Maintenance levels will therefore be determined by the extent to which the council can secure enforcement through the contract.

Similarly, it was originally envisaged that the consortium would take on board the public utility risk; however, the consortium was very unhappy about accepting price risks associated with energy and water. In the event, such risks have been shared, with the consortium taking on the *volume* risk and the council taking on the *price* risk.

The financial risks for the private sector were also significantly reduced. In the PFI the consortium usually assumes significant risk by providing part of the equity to fund the project (usually around 10%). In the high school project the consortium proposed an alternative funding structure, in which it took on only 1% of the equity. The proposal had financial advantages for the council as equity finance is expensive and the 1% equity proposal reduced the annual charge to the council by around £50,000 per annum. This proposal does however transfer certain levels of risk back to the council. The council would now be required to ensure that the lender, ie the bank, was reimbursed in all circumstances. This liability should be fully covered by guarantees from the parent company of the builder and latent defect insurance surety bonds. In certain cases, however, particularly if a construction defect occurs which has a high cost of rectification and the council's guarantee was inadequate, liability could fall on the council.

These issues, particularly the reduced equity holding by the consortium and the fact that the council will own the asset at the end of the contract period, raised doubts as to whether sufficient risk transfer has taken place. At one time the council's financial advisers even declared the project as neither on nor off the council's balance sheet. It is possible that in this type of situation, risk distribution can be manipulated to ensure off balance sheet status, with value for money almost becoming a secondary issue. Finally, the Scottish Executive decided that there was sufficient risk transfer and released the level playing field funding without which the project was infeasible for the council.

Conclusion

In conclusion, we return to the question posed in the title of this article: 'Is the PFI a good deal for the public purse or a drain on future generations?' Our discussion of additionality suggests that PFI is not facilitating significant amounts of additional investment that the public sector could otherwise not afford. Thus the case for PFI being a 'good deal' cannot rest on this argument. The vfm case for PFI remains uncertain for the reasons discussed, mainly because of the lack of innovation (observed in our case studies) but also the uncertainty of expected gains over a 20 to 30-year contract. Neither can we rely on risk transfer to ensure that the PFI delivers. As discussed, risk transfer is believed to be central to achieving vfm. However, the uncertainty of risk valuation (or even its absence in some project Business Cases[7]), and the unpredictability of events over the life of the contract, suggests that it would be unwise to rely on this vehicle alone. Indeed, our research indicates that risk transfer under PFI may not be as significant as the initiative's proponents claim.

Whether PFI is a good deal for the public purse

depends essentially on individual projects being certain of achieving vfm over the life of what can be very long-term contracts. With the current arrangements, a PFI project only has to prove vfm against the public sector alternative at the point of contract signature. However, changes will take place over the life of the contract (in some cases at a very early stage) which have an impact on the charge to the public sector. In these instances, the public sector cannot even rely on competition to achieve vfm, because of the monopoly power of the PFI operator. Thus, the jury is still out on whether PFI does in fact deliver vfm over traditional procurement. In addition, in our research we observed an obsession with balance sheet treatment, due to the fact that public subsidy for PFI projects has been tied to this. There is clearly a danger that vfm may be compromised in some instances in favour of achieving the 'correct' balance sheet status. Thus, we may yet see the PFI as a drain on future generations.

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Notes

[1] With PFI the private sector builds an asset (for example, a new school) which the public sector then pay a charge to use. The private sector is responsible for maintaining the asset and for the facilities management, including services like cleaning and catering.

[2] The Golden Rule states that on average over the economic cycle, the government will only borrow to invest (not for current spending) and the sustainable investment rule states that public sector net debt as a proportion of Gross Domestic Product (GDP) will be held over the economic cycle, at a stable and 'prudent' level.

[3] The Treasury Taskforce.

[4] It is important for the local authority, for example, to avoid instances where a shortlisted bidder withdraws due to lack of resources. This can have a detrimental impact on the competitive element of PFI.

[5] Transfer of Undertakings (Protection of Employment) Regulations (1981).

[6] 'Section 94 capital allocations' refers to the amount of borrowing for capital investment that local authorities are allowed to undertake. It is controlled by the Scottish Executive. The system is currently under review.

[7] See Treasury Taskforce Private Finance (2000).

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