The Private Finance Initiative in the UK

"another fine mess you got me into"
but
"the report of my death was an exaggeration"

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The stolen catch phrase from Laurel and Hardy – "another fine mess you got me into" – sums up where we are now with the Private Finance Initiative in the UK.

Project delays, windfall profits, off-balance sheet funding, accounting irregularities, ideological arguments and sheer bloody mindedness are all very much to the fore - and are often espoused with evangelical zeal. It is also true that you can hardly pick a newspaper up in the UK, without there being some new revelation on the subject.

In terms of the sparks in the PFI tinder box, however, there were two. Firstly, in the wake of Enron *et al*, accounting standards became an issue, in general, and a big issue, in particular, for PFI. Specifically, the treatment of bidding expenses, the calculation of profit margins, carrying values and off-balance sheet debt were all critically examined and, in the case of some corporates, found wanting.

Secondly, was the proposed part privatisation of London's Underground railway – also known as 'the Tube'. In particular, the Major of London, Ken Livingstone, is vehemently opposed on the grounds of excessive profits for the private sector participants. Fanning the flames, too, while the debate continues, is the fact that the meter is running - to the extent that a total of some £100 million has been spent on fees to consultants and advisors, without even a new train wheel having been polished.

PFI has, thus, been palpably wounded – to the extent that some of its opponents say the concept is dead. However, I do not believe this is true. Indeed, take another American – albeit a more literary one - Mark Twain. On reading his own obituary in the St Louis Chronicle, he sent a cablegram noting "the report of my death was an exaggeration".

In at the birth

A private financed public sector is not a new concept, with French canals and bridges privately financed in the Seventeenth Century. Other projects have included toll roads in France and Spain and power stations in Italy, Spain and Portugal. In the UK, however, it officially kicked off 10 years ago, in 1992, with a breathless flurry. Indeed, it was to be the panacea for both the seamless provision of infrastructure and for smoothing the cyclicality of contractors' earnings. It's originator, the UK Government (at the time the Conservatives were in power) embraced the concept because here was a way to keep capital expenditure off the books but yet have new bridges, roads, hospitals and the like (as long as there was risk transfer, the cost was excluded from the Public Sector Borrowing Requirement or PSBR). The other criterion was that PFI had to provide value for money or VFM (in this way, too, it reduced the PSBR). Put simply, it was ‘build now, pay later’.

The other bonus was that it allowed the government to step back from its continuous battle with the UK construction industry, where three-quarters of projects ran over time and two-thirds over budget - followed by years of claims and counter claims. This was particularly acute in the provision of trunk road and motorways, where costs had run at, on average, 29% over budget. In addition, logistical and labour relations’ headaches were to be consigned to the dust bin as private consortia assumed operational responsibility – while payment, on all fronts, was to be made from revenue expenditure.

Finally, the State would also eventually own the assets – in 20 or 30 years - albeit that this yielded little political gain, even in the medium term.

Definitions

However, it is also important to realise that there are different types of projects which qualify within PFI –as it has become something of a catch-all. Fundamentally, PFI is an alternative method of procuring services for the public sector. Historically, the public sector procured capital assets from which it then based its services – now someone else buys the assets and then sells services to Government or public authority, albeit that the Government ends up owning the asset when the concession period ends. This is PFI at its most pure and ‘financially free standing’.

However, there can also be joint ventures or Public Private Partnerships. In my book, PPPs can have both public and private capital and/or equity (part privatisation, if you will). What is more, ownership does not revert, ultimately, to the Government. One current example is NATS, the National Air Traffic Control Service where the public/private split it 50:50 (note, too, that the finances of this PPP have wobbled seriously in the wake of September 11). Another is London Underground.

Finally, there are ‘services sold’. This may take the form of a private company supplying an NHS hospital with kidney dialysis services, clinical waste incineration etc. However, the provision of prisons is also included here. Indeed, consortia provide accommodation and prisoners’ services to Her Majesty’s Prison Service (HMPS). Sure, there is an element of ‘leaseback’ but to avoid this showing on public bodies’ spending allocations it is necessary to include a service incorporated with a facility lease i.e. HMPS does not lease the prison, rather it pays for a complete service provided to the inmates. This is an extremely important distinction, according to Owen and Merna of UMIST.

Climate for change

In any event, PFI, in all its forms, arrived at a particularly good time. Indeed, the climate was right for such a change, as the UK had undergone a dramatic shift from public to private ownership in the preceding decade. For example, utilities such a gas, water, electricity and telecoms had been sold off by way of a mammoth state privatisation programme – as had British Airways. So the populace were familiar with the broad concept.

As for the contractors, they welcomed PFI with open arms - here was a way of capturing new work, hopefully on preferred terms, with both project and services related income. In turn, PFI would avoid the traditional dog fight to win new work, limit the number of competitors and iron out the undulations in the country's total workload. In my view, however, taking a modest single figure percentage stake in a new project was simply a means to an end for the contractor. OK, he would probably generate a decent return in time, but the average company could probably only afford/chose to have, say, half a dozen investments before needing to turn its capital. Indeed, if it was possible to win the work, without the investment, this would be preferred; the metamorphose of John Laing aside i.e. this company has exited construction and housebuilding and is now a purely developer and manager of PPP and PFI projects.

£22 billion so far

On the general funding front, there was also an initially enthusiastic response and there was an abundance of potential capital; and this remains the case. Indeed, as at July this year the capital value of some 500 PFI schemes which had been completed was £22 billion plus there is a further £14 million worth where formal contracts had been signed – and £64 billion of schemes in the pipeline (all numbers sourced from the Office of Government Commerce, July 2002). This compares with annual UK construction output of around £80 billion.

So what has gone wrong?

Timing and cost are probably the two biggest issues, wrapped up with a fair portion of bureaucracy and red tape. Indeed, pretty much all PFI projects in the UK took considerably longer to materialise than was ever expected – for which there are a number of reasons. Firstly, everyone including the Government was finding their feet (remember it was newly a specifier of services). It also had to ensure value for money (against a public sector comparator) and the transfer of risk – which, in turn, can be allocated in two ways: through a payment mechanism; and specific contract terms. For the Government it needed/needs to fulfil it's 'off balance sheet' accounting objectives and keep the risks off its books, whereas the purveyors of PFI believed they were expected to shoulder too much.

A further dimension was that PFI consortia were pricing a 20 or 30 year 'contract', with all the detail and analysis which this entails. For example, most PFI contracts are as thick as the London phone book.

The Government also encountered extensive opposition from a range of sources: local government (particularly); health authorities; planners; trade unions; and Members of Parliament of all political hues, including those in the incumbent ruling party. Herein, much of the criticism was centred on the cost of schemes i.e. PFI will always be more expensive because no one in the private sector can borrow money as cheaply as the Government. Similarly, as PFI schemes were up and running – and some re-specified and/or refinanced - it was claimed that a 'gravy train' of profits arrived for PFI participants; and the catch phrase "build now pay MORE later" was coined.

Subsequently, this year's annual conference of the Labour Party (also the Government) witnessed the collective UK trade unions' vote negatively on PFI as a concept and practice – and this remains a crowning moment for PFI sceptics.

In turn, this dithering and controversy fed into the design and the project letting market - and the gap between 'gleam in the eye' and breaking earth became even more protracted. The Government was attempting to appease all parties and still ensure value for money, but it was costing the contractors and other participants money – and it was very expensive (often several £100,000 even over £1 million in bidding costs for a single project, with no guarantee of success). This lessened the enthusiasm of all participants but, particularly, the crucial prime funders, who became increasingly nervous.

Railtrack and other 'winners'

Other very significant externalities include the collapse of Railtrack plc (which had also been privatised) and the whole issue of safety - of absence if it - with rail maintenance in private hands. There has been a startling poor recent record on the railways in the UK, with a number of accidents and significant loss of life. More recently, another privatised company, British

Energy plc, the UK's largest producer of electricity, appears to be virtually bankrupt – and this endears no one to private owners of public assets.

Going further back, the life and times of that mother of all PFI's, Eurotunnel has also been used in evidence for the opposition. Sure, the English Channel Tunnel was the largest civil engineering project in the World – and at 38 kilometres (times three) it is still the largest undersea tunnel; while in total the bores were 50 kilometres long (times three). However it took almost eight years to build (from 1986 to 1994) – which was a third longer than anticipated and it cost £10.6 billion against an original estimate of £4.8 billion – more than double. OK, the specification changed and it was claimed, by the builders as represented by Transmanche Link, that Eurotunnel wanted a 'Rolls Royce motor car for the price of an Opel Cadet'. However founding shareholders committed some £2.7 billion at 1990 prices – against Eurotunnel's market capitalisation of circa £1 billion – at 2002 prices – today. That said, the company now does appear to be making progress, but it has still paid no dividends to shareholders – and most won't probably until 2004. Note too that the concession period was raised from 55 to 65 years.

The 10 contractors who formed Transmanche Link

Bouygues
Dumez*
Societé Auxillaires d'Enterprise (S.A.E)*
Societé Générale d'Enterprise (S.G.E)*
SPIE Batignolles*

Balfour Beatty
Costain
Tarmac*
Taylor Woodrow
Wimpey
**have since merged or been taken over; Balfour Beatty was demerged from BICC plc.*

The industry

The progress of the Channel Tunnel is not a typical of the industry (albeit, that the contractors did very nicely, thank you, out of the early share and share warrant sales). Yet by comparison with other large scale civil engineering projects it wasn't half bad. For example, the Suez and Panama canals were 50 times over budget, while the single bore Seikan rail tunnel connecting the northern island of Hokkaido to mainland Japan was completed after taking 24 years to build, which was 14 more than planned (according to D W Cooper, University of Manchester).

In any event, the investment community does not trust contractors and their siblings. They have let investors down too often – both on the quality of earnings and an apparent inability to bring in projects on time and on budget. For example, the average historic Price Earnings Ratio (PER) of a basket of leading UK contractors is generally half that of the market; today it is 8.4x, which compares with the UK All Share Index's 20.1x. Note, too, that the value of all publicly quoted companies in the UK construction industry (including building materials companies, housebuilders, contractors and merchants) is around £30 billion, which is about the same as Lloyds TSB plc, the bank.

However, perceptions of the industry were beginning to change, in the wake of a number of Government sponsored task forces, including the Egan Report: "Rethinking Construction" from July 1998 and an increased use of partnering – between client and builder – of which PFI became the grown up version. But then came, Enron and World Com and a hue and cry into accounting standards. In turn, this spilled over into PFI, which was and is still relatively new – and was increasingly the subject of criticism, with the Mayor of London at the head of the queue. In turn, this put the skids under the share prices of a number of PFI pioneers. This included support services companies, including those quasi contractors, who have been PFI pioneers: AMEY, W S Atkins, Capita, Interserve, Jarvis, Mowlem and Serco – and some recently joined the '90% club', in terms of share price attrition. It also spilled over into the construction sector with AMEC, Balfour Beatty, Carillion and Mowlem, in particular, having a pretty tough time.

Name	Today*	% change from peak	52 week High	52 week Low
AMEC	186	-62	490	175
AMEY	31	-93	414	24
Atkins	90	-87	701	49
Balfour Beatty	164	-42	281	120
Capita	264	-48	510	160
Carillion	123	-47	231	106
Interserve	190	-67	581	177
Jarvis	279	-52	584	190
Mowlem	142	-47	268	119
Serco	177	-58	420	114

**28 November 2002*

Average movement from peak levels of:	
Above sample	-60
UK Building Sector	-31
UK Support Services	-42
UK All Share Index	-22

So in my view, sentiment towards PFI has hit rock bottom and it probably scores just two or three out of 10 at this time.

Dancing on its grave? - seven reasons why PFI is wrong

In terms of articulating the case against PFI, the UK's largest trade union, Unison had a fair old crack in a timely audit published in September of this year and entitled "Failing our Future". In its view there are seven reasons why both Public Private Partnerships and PFI will not improve public services:

1. The public service ethos. By this is means the public service cannot allow services to fail – but companies can and do abandon contracts (and here it quotes the fact that UNITE pulled out of a thirty year deal for student accommodation at Sheffield University). The Union also highlights the practice of refinancing PFI projects which has generated windfall profits – which could otherwise have been ploughed back into the service.

To be fair, this was a flaw – and it was sometimes undertaken in secret. However, the Government has announced new arrangements for sharing the benefits and a 50:50 approach has been taken on most contracts let since June 2001. Unison also underlines the fact that in 45 PFI schemes the same accountants acted for both the advisors and the public authority. It also quotes the Government's Public Administration Select Committee, which says that the public service ethos "may be put under strain by the profit motive".

2. Public finance drives the use of PFI. Instead of levering in extra investment, it is a substitute. Indeed, "the Government could comfortably pay for the entire PFI and PPP programme without breaching the fiscal rules it has set itself". It is also concerned about the government using off balance sheet financing *a la* Enron, thereby concealing its true financial position. And here it quotes the example of a prison in Scotland, which is neither recording in the accounts of the Scottish Prison Service, which is employing the asset, or in those of the private sector operator, Kilmarnock Prison Services.

3. PFI costs more. The objections here break down into four categories: firstly, the private sector pays more for debt than the government; secondly, there are high set up costs; thirdly, PFI is a very profitable business for the providers; and finally, there is escalation of both scale and running costs once the scheme has commenced. It also says that "just because a PFI scheme is value for money, does not mean that it is affordable to the school or hospital that has to pay for it".

Furthermore, for each of its points, Unison provides evidence. However, I will highlight just one or two i.e. according to a British Medical Journal (BMJ) study, the London Borough of Tower Hamlets paid set up fees of £4 million for a £48 million education project i.e. 8% of the capital cost; AMEY expected to make returns of 20% on its £60 million investment in London Underground; and a range of health projects where original tender prices soared on closing as PFI projects – the worst being the Worcester Royal Infirmary which more than doubled to £110 million.

4. PFI "profits from people". A two tier workforce can be created, where new staff are taken on by private contractors at inferior pay and conditions. Why? because "the labour component of most services is a major source of costs savings and, of course, a major source of profits to the private sector".

5. PFI goes wrong. It has not produced the step change in quality and performance that the Government claimed it would. The evidence shows: time and cost overruns; projects bailed out by the Government; poor design and quality; plus the total failure where PFI has been used for large scale Government IT projects. Again, examples are profuse: the BMJ says that PFI projects in the National Health Service (NHS) overrun on cost to the tune of 12.5%; whereas it used to be 6.3 – 8.4%; London & Continental Railways which was awarded the contract to build the a high speed rail link to the Channel Tunnel went bust and had to be bailed out to the tune of £4 billion; and at the Ministry of Defence, EDS failed to make a new £300 million IT system work for the armed forces administration.

6. **PFI is not value for money**. The National Audit Office and Jeremy Colman its Deputy Controller and Auditor-General said, in June last year, that VFM exercises were "pseudo-scientific mumbo-jumbo where the financial modelling takes over from the thinking…It becomes so complicated that no one, not even the experts, really understand what is going on".

For its part the Union says that the VFM test is flawed. Take the discount rate of 6% (this is used to bring all future payments – over, say, 25 years in the case of PFI – to today's values so that the real costs of different schemes can be compared). Unison, however, and many others have argued that this rate is too high. And, according to Professor Pollock at Cumberland Royal Infirmary, reducing the discount rate by 0.5% was enough to make the public sector comparator better VFM than the PFI option.

To be fair, in August of this year the UK Treasury issued a consultation paper which proposed reducing the discount rate to 3.5%. However, on this basis, most of the existing PFI schemes would have failed the VFM test. Finally, the trade union says that in determining value for money, the inclusion of risk transfer is absolutely key. Here a BMJ study says that for 11 PFI hospitals, they were only better VFM than the public sector comparator after risk was transferred. It also concluded that "the value of risk transferred is remarkably close to the amount needed to close the gap between the public sector comparator and the PFI". Also as Mr Colman said "people have to prove value for money to get a PFI scheme. But because that is wrongly seen to be demonstrated only by the public sector comparator, it becomes everything. If the answer comes out wrong you don't get your project. So the answer doesn't come out wrong very often".

7. Private Companies make unacceptable profits. The stream of guaranteed payments for at least 25 years from a PFI provides a new and more reliable source of profits than that in traditional construction. But these profits should be directed at crucial public service. For example: AMEC quotes 3% margins in construction work but 15.8% in PFI; Serco makes 8.9% on PFI compared with 3.5% elsewhere; 20% projections on the London Underground PPP; and 16% on schools in Scotland.

I have quoted the Unison Audit at some length, in the interests of offering a balanced view of PFI. I also think that it makes some first class points. For example, I believe that the entire value for money argument requires a re-think (more of which later); but already the Treasury has proposed changes to the discount rate. Similarly, the level of set up costs is too high and it is also true that the some practitioners in the accountancy profession have been exposed for acting against their clients' interest. Finally, any sanction of a two tier workforce, wherein private sector participants were disadvantaged cannot be tolerated.

Elsewhere, however, Unison's arguments are less cogent. On the claim that 'public service cannot fail', how would it describe the current Firefighters' strike? Nor is it true that the Government can 'comfortably pay for the entire PFI and PPP programme without breaching the fiscal rule it has set itself". Next, on the costs front any hire purchase costs more than paying up front – and that it what the Government is doing. As for PFI going wrong – what doesn't? The performance of the public services in the UK is poor. Finally "unacceptable profit"; this is as long as it is broad and has to do with the allocation of risk over 20 or 30 years.

Chiselling the tombstone? – why it is claimed that PFI is not value for money (this time from 'the right')

Then from the other side of the political spectrum has come, in October, a survey of public sector finance directors, project managers and accountants involved in PFI projects. It was organised by the Association of Chartered Certified Accountants (ACCA) which gathered replies from nearly 200 members working in local government, the NHS, central government, higher education and other areas (such as broadcasting, prisons etc).

The results of the ACCA survey can be summarised as follows:

- only 1-in-5 felt that their PFI projects had provided value money

- 57% did not believe that PFI was value for money (and a third of these said this strongly);
- 42% do not think that PFI is having a beneficial effect on public services (and only 2% did)
- almost 60% did not believe that all schemes were objectively tested to see whether public capital would be a better route;
- only 4% strongly believes that PFI has enabled the Government to meet is commitments to increase investment in public services
- 57% agree that public sector organisations are prevented from achieving value for money, as PFI is the only available way of obtaining the necessary investment in public services

The small scale of the survey can be questioned as can the degree to which those surveyed had an overview of the projects in which they were involved. However, the ACCA said that members' comments showed that they believed the benefits of PFI were "far out weighted by disadvantages. Many professionals have real concerns over the cost, bureaucracy, time taken in progressing schemes and long term revenue commitments involved".

As a counter, the Office of Government Commerce maintains that "in the right circumstances" PFI can provide good value for money and this is supported by National Audit Office (NAO) reports. For example in November last year, the NAO found that 81% of public bodies involved in PFI projects believe that they are achieving satisfactory or better value for money from their PFI projects. Similarly, 70% of authorities and contractors view their relationship as being good or very good, with only 4% of contractors feeling their relationship with authorities was poor. At the time, there were over 400 PFI contracts in force committing departments to future expenditure of around £100 billion. However, there was also limited experience of the issues that arise once a PFI contract has been let.

Where do we go from here?

I agree with the "real concerns" by the ACCA – as do, most probably, all participants in the PFI process. However, negative conclusions are not atypical at the bottom of any bear market – and that is where we are.

It is, of course, easy to be critical, just as it is to be ideologically blinkered. However, I believe that PFI is here to stay and the British Prime Minster, for most probably the next seven years or so, agrees. In his key note address at Labour's annual conference in September he said that the consumer who is using a new hospital or school does not really care where the money for it came from, as long as the facility is there. And I quote:

“But let me make one thing plain. We are the only Government anywhere in the Western world that this year, next year, the year after, is increasing both health and education public spending as a percentage of national income. The only one. That is our commitment to public services.

We said schools and hospitals first. We're building them. Lots of them. And I am not going to go to parents and children and patients in my constituency or any other and say I'm sorry because there is an argument going on about PFI we're going to put these projects on hold.

They don't care who builds them. So long as they're built.

I don't care who builds them. So long as they're on cost, on budget, and helping to deliver a better NHS and better State schools for the people of Sedgefield and every other constituency in the land.

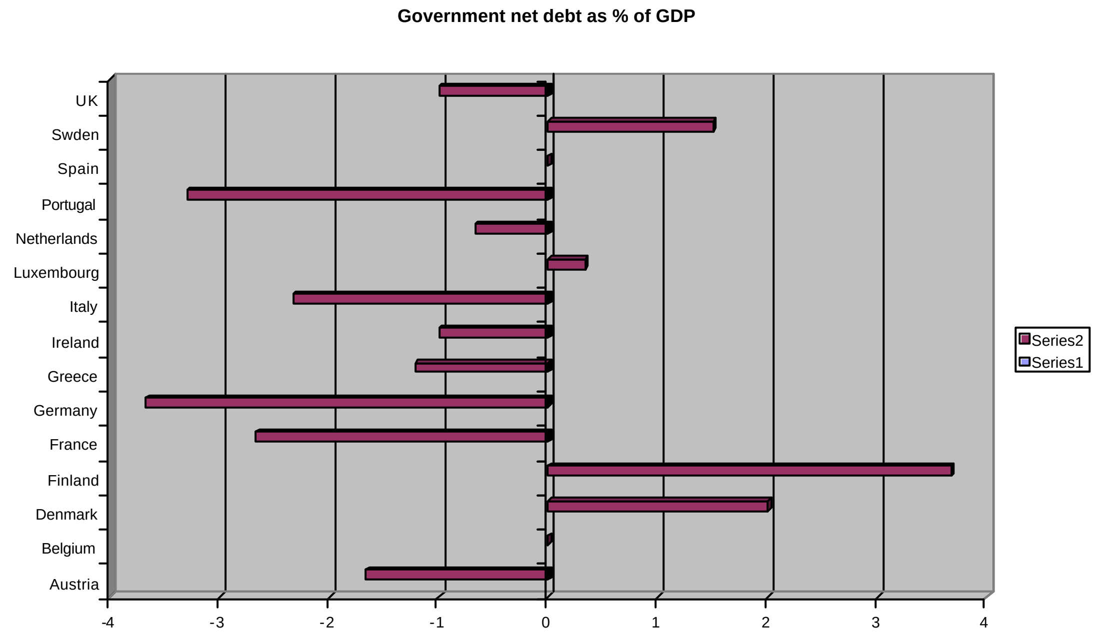
Between 1979 and 1997, ten new hospitals were built. Through PFI since 1997, 15 new hospitals built and 100 on the way. 550 schools are being re-built or modernised…All under PFI. And every single part of the service remains universal and free at the point of use.

Come on: this isn't the betrayal of public services. It's their renewal.

All that is happening is that here, as round the rest of the world, we are dividing means and ends. The ends, universal provision remain the same. The means of delivery, partnership between public, private and voluntary sectors and between state and citizen, change”.

European budget deficits

This is also true elsewhere in the EU where everyone wants to improve infrastructure – in scale and speed - and services (but not pay for it directly). And this is particularly true of major, physical infrastructure links such as bridges, tunnels and rail lines (for example, the new fixed link between Denmark and Sweden). But where will they find the money without PFI or PPP?



Under the Maastricht agreement, there has been particular emphasis on reducing public expenditure (initially, in the drive to monetary union). However, in examining the chart showing the 15 EU countries and their Government's respective net debt for 2002, only four are in surplus, two neutral and the balance in deficit, with three (Germany, Portugal and France) either above or very close to the 3% EU ruling. Also, amongst Europe's top five by scale, both Germany and France stand out as facing serious problems; and together they account for 37% of total construction output in the 19 Euroconstruct countries. Furthermore, the three nations in significant surplus – Finland, Sweden and Denmark – account for just 6% of the construction pot.

So PFI, as a means to an end, is not simply a British issue, it is a European issue. Similarly, pressure on public financing is not restricted to one region and there is growing interest worldwide, especially in Asia's emerging nations.

Positives and negatives

To recap, then, PFI is permanent but it is flawed or at least its implementation is; and in devising a solution, both these conclusions need to be kept in mind.

However, let’s focus in the positives:

- ‘need’ is a positive which, in turn, underlines the abundance of opportunity (*viz* the £22 billion of deals done in the UK and £78 billion on their way);
- national or regional governments are, in principle, supporters; if not always local authorities;
- an abundance of capital to invest (by example, look at the number of private equity funds brim fill with cash);
- projected returns are attractive;
- contractors, professionals and hangers-on see a potentially high quality source of work.

Meantime, in the negative corner, we have:

- timing i.e. the delay between conception and use;
- costs / value for money;
- bureaucracy;
- opposition from trade unions and ideological objections;
- ‘excessive’ profit accusations;
- negative audits / surveys such as those from Unison and the ACCA;
- bad track record and PR e.g. Railtrack, safety, London Underground and Eurotunnel as a precedent;
- lack of trust for the contractors in the efficacy of their earnings and estimating (outturn timing and cost);
- accounting issues, including revenue forecasts, bidding costs and off-balance sheet debt.

PFI’s prime foundations are solid

In my view, the positives are more fundamental than the negatives – which means that the prime foundations of PFI are solid. Indeed, four or five of the nine negative categories are principally definitional, organisational and / or logistical challenges – best practice, if you will. This is not to underestimate them, but they are curable. This is particularly true of the timing issue – and, thus, part of the cost equation. Bureaucracy, is difficult, but could be solved by redefining the process and the public sector participants (education would also help).

On accounting, this is most probably on the mend and we are currently in an awkward transitional phase, where better revenue forecasting requires better models, better information and investment. The opposition issue will take longer – but a few positive surveys would help (as antidotes to those like the Unison and the ACCA). For example, these could focus on the new PFI built environment and resulting facility.

This leaves bad track record, poor PR, the contractors' myth and value for money.

Within track record, the safety issue, especially, needs fixing - but there does appear to be a will to do so; whilst elsewhere, a favourable outturn on London Underground would do wonders. As for the contractors – their reputation precedes them: perennially over time and over budget. However, even here in the wake of number of learned audits – including the Egan report (see earlier) there does seem to be a genuine willingness to change for probably the first time. What's more PFI – or partnering on a grand scale – lends itself to co-operation rather then confrontation. To be fair the industry still has a very long way to go, but it is at least moving in the right direction. Incipient rationalisation, here, will also help this process; and on this I will digress for a moment.

Industry rationalisation

In my view, contractors tend to be the bridesmaids – in that they are invariably the last to arrive at the altar in their own right and in the title role. By this I mean that in heavy building materials, there may be one or two more major deals to come, but it is pretty much done and dusted. Similarly, in UK and US housing there has been a rash of activity. But, in contracting and construction there has not been that much activity.

To be fair, since 1995-96, there has been a bit around the edges: Tarmac/Wimpey; Mansell/Raine; Kaverner/Trafalgar House; Galliford/Try; Skanska/Kaverner; Lend Lease/Bovis; and O'Rourke/Laing. Similarly, internationally, there has been: AMEC/Spie; the creation of Vinci; Hochtief/Turner; AMEC/AGRA; HBG/NBM (via Dragados, itself in play with Aurea and Acesca, which are, principally, toll road operators) plus the dismemberment of Holzmann and rationalisation in Scandinavia. In my view, however, there will be significantly more in the future. This will be driven by a range of factors including, the sheer scale of tasks and clients, the cost of bidding, the rise of PFI, and the risk/return ratio combined with the industry's polarisation.

Scores on the door

In any event, back to PFI. In examining, the two lists - positives and negatives – above, I have scored each category (subjectively, to be sure) with the following result: the positives score 82% and the negatives score 60% (given that many of them are curable). Thinking laterally, if the first score was the gross return on an opportunity and the latter the WACC (weighted average cost of capital), then investment would be a no-brainer.

The trick is, of course, to fix what is broken. As mentioned above, there is a major definitional, organisational/logistical challenge to be grappled with – and most probably, the creation of a new executive, separate from (albeit accountable to) government. Similarly, new practice needs to be introduced, along with new accounting standards and forecasting methods. In addition, a full audit of what has happened under PFI needs to be undertaken and a catalogue of the benefits formulated – and promulgated far and wide.

It is the last point, which is probably most urgent. As I have shown, the analysis of PFI's performance is, at best, patchy and subjective. And, as the Institute for Public Policy Research (IPPR), which is convinced of the benefits of PPPs, said last year, an evidenced based approach to policy is needed. "A commitment is necessary to pilot, monitor and systematically evaluate a spectrum of partnership arrangements. Depending on the evidence that emerges PPS (including PFI projects) could be rolled out or rolled back".

- **a banker's view**

Similarly, Dexia Public Finance Bank has recommended standardisation of contract documentation – which would help considerably (particularly with smaller schemes) - as would streamlining the procurement process. In addition, it pushes for longer term relationships between sponsors, investors and funders plus 'bundling' of schemes, where appropriate. Finally, Dexia says it and other banks have extended the maturities over which they are prepared to lend and have developed greater 'multi-product' capability offering traditional project finance, lending, advisory services, equity and mezzanine finance and bond issuance.

- **Eurotunnel says**

John Noulton of Eurotunnel has also spoken about the lessons learned on the Channel Tunnel which could be extrapolated to PFI. Firstly, he believes that the roles and responsibilities of the Government need to be agreed in the beginning and adhered to. Next up, a strong owner should be in place from the word go. Thirdly, finance should be raised in a form and at a price that accurately reflects the risk. His final point, however, is a controversial one: contractors to be selected by competitive tender after substantial pre-planning has been done.

The VFM test is flawed

Next, the crucial issue of cost and I quote here from a paper produced at the University of Bristol by Paul Grout in December last year. The traditional way to assess whether private provision is better than public, is to undertake a comparative cost/benefit analysis. However, these are neither popular or precise; hence the value for money (VFM) test. But this simplified approach is the source of the problem - and it is flawed because it underestimates the benefits of private sector provision.

- **comparing apples with oranges**

The VFM text asks “does the Treasury pay less for private provision than public?” If the answer is “yes”, then the private route is followed. In the case of a road, the following occurs. First, the Government calculates the cost if it procures and owns the road directly – which becomes the Public Sector Comparator (PSC). The alternative is to assess how much it would have to pay a private consortium for every vehicle using the consortium’s road for the next 30 years or so. In the first case, the Government is buying the road, whilst in the PFI solution it is buying services. This is comparing apples with oranges and means that the government treats “everything like a fruit cocktail”.

Grout goes on to use the example of an office building. The PSC is analogous to the cost of hiring a contractor to build an office, while the PFI alternative is equivalent to calculating the cost of paying all future rents but failing to take account of the risk. In other words, the ‘build cost’ is a front end cash flow. However, the present value of the rents over 30 years will be massively more risky. They should, thus, be discounted at a higher rate because of uncertainty. If not, then the building project will look as if it is very profitable when it is not i.e. the present value of the rents will be grossly overestimated. In this way, with the help of the PSC, the false conclusion is that building the office is cheaper.

Taking this a step further, economic analysis identifies four areas where “the apples need sorting from the oranges”: the failure risk; the inherent risk of services; the treatment of quality; and the role of profitability.

- **the failure risk**

Firstly, the current rules ignore the fact that the payment to the contractor may not be made i.e. the failure risk is not recognised. In short, existing methodology does not take proper account that the costs are incurred by the public sector, under conventional procurement, whether or not the desired benefits are received; whereas under PFI, the private sector pays only to the extent that it receives these outputs.

- **the inherent risk of services**

Secondly, what is certain is that the omission of failure risk and the inherent service risk in the discount rate overestimate the cost of private sector delivery in comparison to the PSC. For example, the volume of vehicles on a road will be prey to the state of the economy.

- **the treatment of quality**

Thirdly, the VFM test fails to recognise the quality of benefits delivered. Indeed a common criticism of PFI is that it fails to come up with really innovative approaches. This is not altogether surprising if these do not receive their true value in the assessment. It is far easier to replicate the public sector project at a lower cost.

- **the role of profitability**

Finally, profitability; with the current system the ability of the private sector to deliver more cheaply than the public sector is only seen to have value when it reduces the Treasury cost. However, PFI should be thought of as part of an overall productivity drive; if it is, then better productivity is the true test (with the spoils shared).

Grout then pronounces two conclusions. The net impact of the failure to recognise the above effects seems to work almost universally against the private sector (which is contrary to popular conception).

Second, the failure to recognise these effects is very significant. In fact, Grout argues that the Treasury should use different discount rates for PFI projects and the PSC. Furthermore, because PFI projects are long lived the consequences of small differences may be huge. For example, if the PFI discount rate is wrong by 1%, then the cost of private provision may be overestimated by around 14% of a 40 year project.

- **where do we go from here?**

A good first step would be to conduct a study of the sensitivity of existing projects to differences in discount rates between the PSC and the PFI model. Looking just at existing projects, of course, misses much of the point. Indeed, it is the projects which failed to get going where the effects may be greatest. We need a reassessment of the assessment procedures and cannot engage in a sensible PFI debate until we have a clear idea of the financial benefits.

New front men

Finally, on the contractors, some amelioration of image and practice is at hand – but as part and parcel of this, they should not be the front men on the PFI process; we need a new leader in the form of a PFI professional (as with John Laing). Similarly, they should be relieved of their investment requirement. If such a climate was to be created, the wall of money out there would be readily scaled.

Conclusion

PFI is a debate that can be won; indeed needs to be won. It is also a vital element of economic growth.

- **Severn Crossing**

It is also true that there have been unqualified successes in the UK. Indeed, the Second Severn Crossing – linking the west of England with South Wales - has been hailed as "the perfect PFI". In reality it was a cable-stayed bridge with a total length of 912 metres and a clearance above the water of 37 metres. It was let as a £331 million DBFO – design, build, finance and operate – contract to a consortium led by John Laing and GTM Entrepose (now part of Vinci) and including the Bank of America, NT&SA and Barclays de Zoete Wedd.

Together they formed Severn Crossing plc, which also took over the financing (including £122 million of debt), operation and maintenance of the existing bridge over the Severn. Unusually, the development was permitted by an Act of Parliament and took from October 1990 until June 1996 to complete, with a concession thereafter for 30 years. However, should the consortium achieve agreed financial objectives earlier – then both bridges would revert to the Government. Current projections are for 2014 – some 12 years inside the deadline.

- **Dartford River Crossing**

However, my real PFI favourite, and great encourager for the future, is the Dartford River Crossing over the River Thames, to the east of London – and it forms a vital link in London's 110 miles orbital motorway, the M25. In 1980, the second tunnel opened to join the first built in 1963. However, in 1986, the Government invited bids to build a third crossing. The winners were an eponymously named consortium, the Dartford River Crossing Ltd (DRCL). It comprised, Trafalgar House, Kleinwort Benson, Prudential Assurances and the Bank of America, again. (As an aside, Trafalgar House was bought by Kvaerner whose UK arm was then bought by Skanska – who then traded its stake in the consortium).

In any event, DRCL had plumped for a bridge (the first downstream of the City of London since 1894) and the contract and concession agreement were let in April 1987 by Government, via the Highways Agency and another Act of Parliament in 1988. The capital value of the contract was £180 million and the new bridge became operational in October 1991 – on time and on budget. As with the Severn Crossing, DRCL assumed responsibility for the existing crossings of the Thames at Dartford, i.e. two tunnels and for this privilege, DRCL assumed £43.5 million of debt. The consortium also agreed to install new automated tolls and the initial concession period was 20 years, or when the consortium had recovered its costs.

The bridge, itself, is supported by four 84 metre pylons, situated above 53 metre high concrete piers (producing a total height of 137 metres). Galvanised steel cables – 112 of them – suspend the road deck from the top of the pylons. The bridge has a total length of 2.9 kilometres and a central span of 450 metres, which is suspended 65 metres above the river. It was, at the time, the largest cable-stayed bridge in Europe and is a truly magnificent structure.

Furthermore, this is one project where the physical attributes are matched by its finances. As one of Europe's busiest toll stations – with a maximum average of 157,000 vehicles per day – it was most probably always going to be so; and annual turnover for DRCL is running at around £64 million. This means that instead of all three Dartford Crossings being handed back to the Government in 2011 – it will now occur in March, 2003. Herein, too, the original agreement was for tolls to be abolished once the Government assumed ownership of the Dartford River Crossing. However, it has now done an about turn and intends to retain the tolls as a congestion charge. This is expected to bring in a net £50 million per annum (after operation and maintenance costs), which will be spent on transport projects.

Understandably, this move by the Government has proved controversial but it is not unprecedented and is becoming increasingly popular around the world. For example, congestion charging exists in places as diverse as Singapore and Oslo in Norway and - soon - in London.

- epilogue

As with the Severn, the Dartford River Crossing was very much "a forerunner of PFI"; and what better example to have. It was contracted and built inside five years, on time and on budget, it greatly improved traffic flows east of London – both through capacity and automated tolls – and assisted in regenerating the area. DRCL has also been a great money spinner and has paid itself back in little more than 11 years. The Government has also 'inherited' a fully funded crossing with increased capacity – which it now intends to use to generate further capital; albeit there is the spectre of VAT having to be paid on tolls to the EU.

Now, projects do not always come like this – but packaging is key. Similarly, as Tony Blair has intimated: "[the consumers] don't care who builds them. So long as they're built. I don't care who builds them".

Tony Williams
Building Value
December 2002

ENDS