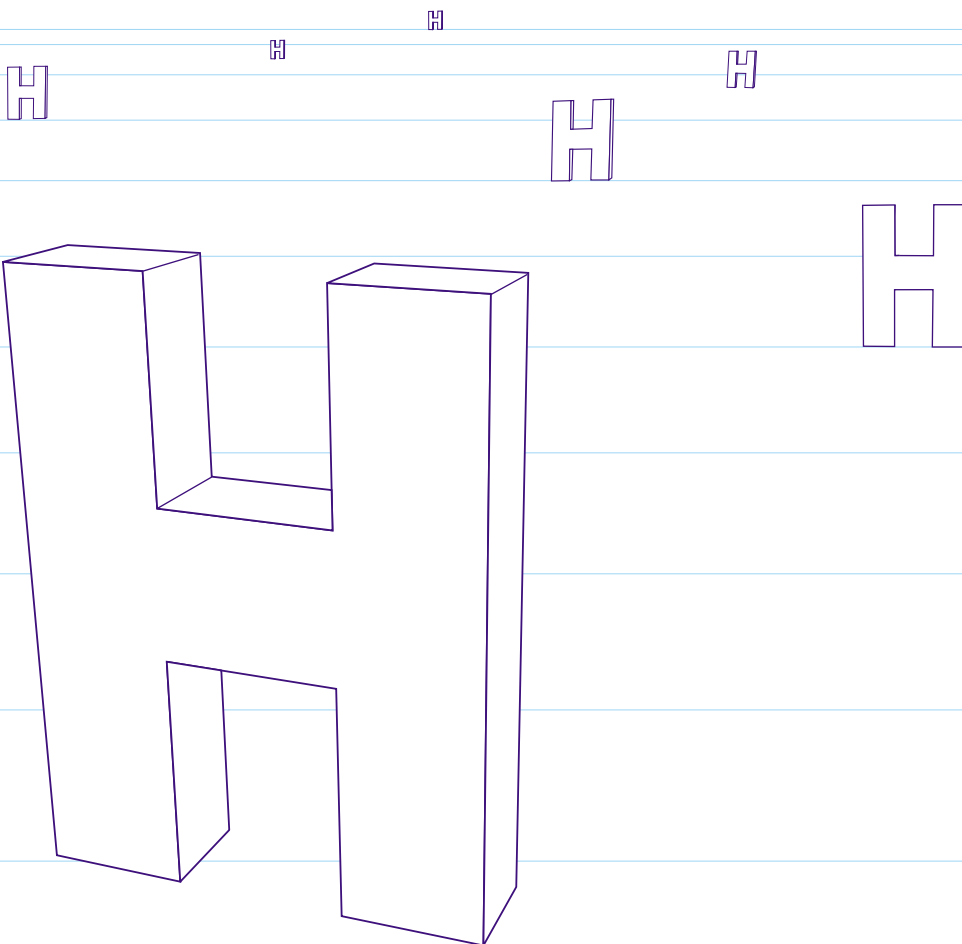




The future of the Private Finance Initiative

Edited by Ann Rossiter

Report of the Social Market Foundation
seminar series 2004



The Social Market Foundation

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Preface

This paper is based on a series of roundtable seminars that were held at the Social Market Foundation (SMF) on 31st March; 27th April and 8th June 2004. The seminars provided a forum for discussion of the major issues facing the development and use of PFI procurement in the UK. Speakers looked at both supply and demand side issues, including how procurement processes might be improved and better value for money obtained for the taxpayer, and how the market for PFI bidders might be fostered. The final seminar looked at the future and optimal scope of PFI, with particular reference to urban regeneration. This paper restates the presentations given and summarises some of the main points to emerge from the discussions. It also attempts to draw some of the main themes together as tentative conclusions.

Our thanks go to all our speakers and to all those who attended the events. In particular, we would like to thank Bevan Brittan LLP, whose kind support made this seminar series and publication possible.

Bevan Brittan 

Overview from the SMF

Ann Rossiter, Deputy Director, SMF

Costs versus value for money

The record of the Private Finance Initiative (PFI) in delivering value for money is, in certain key respects, very strong. The National Audit Office's report on PFI construction, published last year, found that 78% of projects were delivered to the price agreed at contract¹. The Treasury has also published figures showing that only 8% of PFI projects were delivered late², in sharp contrast with other procurement routes (around 70% of projects procured in the normal way were delivered late during 2000/01³).

Critics have sometimes overstated concerns about value for money by not taking into account the transfer of risk involved in PFI projects and therefore drawing misleading comparisons based solely on cost. Such ill-founded criticisms are often an expression of broader concerns about the introduction of market mechanisms into the provision of public services more generally.

The danger with raising irrelevant or spurious problems is that this can draw attention away from more substantive PFI issues. There have been significant problems with some PFI procurements. Particularly notorious are the NIRS2 National Insurance Accounting System, which came in three years late and cost the Contributions Agency £38m in compensation, and the new Worcester Hospital, which is said to have cost far more than original estimates, and lost the MP for Kidderminster his job - one of the few sitting Labour MPs to fall in 2001.

A maturing market

Supporters of PFI point out that many of the problems associated

1 *PFI: Construction Performance*, National Audit Office, February 2003

2 *PFI: meeting the investment challenge*, White Paper, HM Treasury, July 2003

3 *PFI: meeting the investment challenge*, White Paper, HM Treasury, July 2003

with early PFI projects have now been resolved, and that PFI is now reaching, if not maturity, then at least early adulthood, allowing us to take a measured view of its contribution to developing public services. For example, since its inception in 1992, the Private Finance Initiative has grown to be 11% of total public services investment in 2003–04⁴; and there are now over 450 operational new public facilities, including 34 hospitals and 239 new and refurbished schools. Even if some of the more basic issues with early PFI projects have been sorted out (the Treasury has stated that PFI will not be used for IT procurement, for example⁵), given the sums of money involved, and the importance of the projects it is spent on, any improvement in the quality and efficiency of PFI procurement will deliver substantial value to taxpayers.

Procurement issues

Historically, there are several causes of problems in PFI procurement. Dating back to the Ryrie Rules, which governed private finance in the 1980s, is the requirement that privately financed projects could only proceed if they offered better value for money than a hypothetical comparison with the public sector, even if budget constraints meant that the public sector alternative would not go ahead. In practice, procurers must show that PFI is cheaper than a similar project in the public sector, by drawing up the Public Sector Comparator (PSC). However, not only is this extremely difficult to do, but the resulting figure is based on an arbitrary set of assumptions. The procedure is costly and hard for outsiders to understand.

Running a PFI tender is expensive. Under traditional procurement, tender costs may be 0.1% or less of total costs; under PFI, this figure may be 0.5% or higher.⁶ In addition, PFI can involve protracted negotiation, drawing the process out, and inflicting risk and cost on all parties concerned. Obtaining a sufficient number of bidders for real competition can also be troublesome - an issue addressed by the second seminar in this series.

Several PFI projects with large cost overruns – the Norfolk and Norwich NHS Trust, for example – saw changes to the bid specification. This highlights an oft-cited problem with PFI in general: lack of flexibility. PFI projects require specification of

4 *PFI: meeting the investment challenge*, White Paper, HM Treasury, July 2003

5 *PFI: meeting the investment challenge*, White Paper, HM Treasury, July 2003

6 *Constructing the team*, BEC & Sir Michael Latham, reproduced in *Seize the Initiative*, Dr Eamonn Butler & Allan Stewart MP, Adam Smith Institute, 1996

7 *Draft Value for Money Assessment Guidance*, HM Treasury, February 2004

8 *PFI: meeting the investment challenge*, White Paper, HM Treasury, July 2003

9 The total of the figures for the size of the markets quoted here exceed the £7.6 billion of total public expenditure because the former refer to deals signed, some of which have yet to come on stream.

10 *The Private Finance Initiative*, House of Commons Library Research Paper 01/117, December 2001

11 *PFI – the main contractors*, GMB Labour Research Department, September 2001

a series of desired outputs over a 20 or 30-year period, which are then enshrined in a contract. When the needs of the public sector change – as they inevitably do – the contract can prevent a PFI institution from changing with it.

Reforming the PSC

To address these problems, the Treasury produced *Meeting the Investment Challenge* in July 2003 and, in February 2004, draft guidance on *Value for Money Assessment*.⁷ The new approach reduces use of the PSC, introduces a more qualitative basis for appraisal, and moves some decision-making to an earlier, more strategic stage of planning. One aim of these seminars was to gather feedback on the proposals and to discuss how far they are likely to go in overcoming some of the criticisms that have been levelled at PFI procurement.

Creating the PFI market

Before the Private Finance Initiative began in 1992 there was no comparable market for building and operating capital assets in any sphere of the economy. This led to widespread scepticism that the government could ever forge such a market and, though the sceptics have been answered, the PFI market remains a unique and artificial creation. These seminars asked how to push it closer to the competitive ideal.

The market for new PFI projects grew from £666.8m in 1995 to £7.6bn in 2002, 11% of total public services expenditure⁸, but rather than one single market it is many: the participants in IT, road and prison projects are different. By far the largest market is transport, with £8.3bn⁹ of deals signed to September 2001, followed by health (£2.5bn) and defence (£1.9bn)¹⁰. Of the suppliers, the largest are building contractors, like Balfour Beatty, Carillion and John Mowlem, and business services companies, like WS Atkins and Serco¹¹.

One major challenge in the early days of PFI was to convince contractors it had a long-term future. New PFI contractors must make a costly investment in staff, professional advisers and possibly failed bids to establish themselves in the business – this investment is only worthwhile if it can subsequently be defrayed across many successful projects. In PFI the government is the market, and fears that Labour would prove

hostile in 1997, or that PFI might prove impractical for some procurement discouraged potential entrants. A major issue for the PFI is the tension between the need for government to create a market for PFI which provides enough certainty to generate business confidence while retaining government flexibility over spending.

Competing in the PFI market

A second feature of the PFI market is the existence of unusually complicated and long-term contracts. Bidding for a PFI is therefore expensive, and the cost must be written off against profits immediately, though there may be no income for several years. Not only do these bidding costs raise the price of PFI procurement, they hold back the market, as only large, well-capitalised corporations are able to bid. The cost of failed bids also raises the minimum scale needed to operate in PFI: a firm bidding for only one or two contracts runs the risk of losing both, and having nothing to cover its bid costs. Anything that reduces bidding costs will make the PFI market more efficient.

PFI contracts require an unusually complex range of skills: not only building infrastructure, but maintaining and servicing it as well. The capacity to do this is rarely found within a single company, with the result that most PFI contracts are won by consortia. This can have consequences for the structure of the market: for example, even after a facility is built, cash will flow to the consortium rather than directly to the operator. If the operator has only a small share of the consortium it has little incentive to maximise collective profits by running the facility efficiently. PFI must be made attractive to all sections of the market.

Finally, in addition to working capital to cover bidding costs, PFI requires bidders to raise a large amount of equity to invest in consortia. What is more, as an individual company's stake is often below 20%, this must be accounted for as an unconsolidated affiliate, meaning no income can be recognised until the consortium pays a dividend. This depresses the apparent financial performance of companies involved in PFI, making it harder for them to raise the necessary capital, and maintain the favour of their shareholders. Improving the flow of capital into PFI, therefore, is another important issue.

12 *NHS LIFT Prospectus*,
Department of Health, July
2001

Market innovations and the future of PFI

One government response to these issues is Local Improvement Finance Trusts (LIFT) in the NHS. LIFT is a public-private partnership aimed at investment in primary healthcare facilities across the country. It is unique in the sense that, while delivery is via a private sector partner as in a normal PFI, both the local Primary Care Trust and the Department of Health (via a joint venture with Partnerships UK) invest directly in the delivery consortium. In this way some of the constraints relating to capital and lack of operating flexibility can be overcome.

The development of new operating models for PFI will be critical to its expansion into some of the new areas into which the Treasury is keen to see it develop. These include bundling of smaller projects, urban regeneration, waste management and social housing.

Conclusion

The PFI is now out of its infancy, but is still far from maturity. Issues around the initial construction of PFI projects, and the prerequisites of an effective PFI market are both becoming clear, including the need to actively manage the market to ensure value for money. In the future however, it is the management of PFI projects over the 20 or 30 years of their lifespan which will need greatest attention. Effective delivery by PFI schemes for the public services is unlikely to depend wholly on the clarity and foresight of those who drafted the contract. Instead, knowledge transfer and effective relationships between the public sector and PFI providers is going to be crucial. This is the new agenda for the Private Finance Initiative

Seminar 1: how can the public sector get better at PFI procurement?

31st March 2004

Attendees

Chair

Ann Rossiter, Social Market Foundation

Presentations

Geoffrey Spence, HM Treasury

David Finlay, National Audit Office

Paul Davies, PPP Forum/PricewaterhouseCoopers

Chris Wilson, 4Ps

Participants

Paul Alter, BT

Ben Baumberg, Office of John Denham MP

Michael Bourke, HM Treasury

Nigel Campbell, Bevan Brittan

Neil Carmichael, JBP

Jeremy Coleman, National Audit Office

Charles Edwards, APCO

Andy Field, Serco

John Fuller, HM Treasury

Colin Goodwillie, Department of Transport

Tim Gosling, IPPR

Lindsay Grist, PPP Forum

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Ian Paterson, BT

Kate Ravenscroft, Foresight

Oliver Robbins, HM Treasury

Rory Scanlan, Policy Partnership

Conrad Sweming, HM Treasury

On-Yee Tai, PPP Forum

Contributions:

1. Geoffrey Spence, HM Treasury

Introduction

The Treasury has recently developed new Value for Money (VFM) guidance which is to be used to assess potential PFI projects. It is a three stage process: stage one is an assessment of an overall investment programme, carried out by central departments as part of the spending review, to provide an early analysis of whether PFI is likely to deliver Value for Money. The second stage is a project level assessment, undertaken when preparing the Outline Business Case (OBC). Finally, stage three is a procurement level assessment, an ongoing process from submission of the OBC through to commercial close.

It is important to be clear that value for money is not the same as affordability. To ensure affordability, the prioritisation of projects should be done at the options appraisal level, before any procurement decision is made – PFI is not a vehicle for marginal projects. On the other hand, while spending must be set within budgets, short-term affordability should not take precedence over long-term prudent financial management.

The VFM Process

A key goal of stage one, Investment Programme Assessment,

is better engagement between spending departments and the Treasury at an early stage. This would allow “strategic” issues about value for money, affordability, policy, and the approach to procurement to be identified upfront, when it is easiest to deal with them. Further benefits will be increased transparency, which will give both the public and private sectors a better view of future deal flow, and improved departmental budget setting in the 2004 spending review.

The second stage, Project Assessment, contains the final amendments to the public sector comparator prior to procurement. The goal here is to avoid the spurious accuracy of the modeller and to reform the current Public Sector Comparator, placing increased reliance on individual judgement instead.

Procurers at stage three, Procurement Assessment, must not refer back to their numbers at stage two, as this stage is purely qualitative; procurers should use reference cost models for bid evaluation, rather than the stage two PSC. Instead, stage three assessment is an ongoing process of identifying market problems and checking that there is sufficient market interest, market capacity and likely competitive tension to deliver the benefits identified in stages one and two.

Bid evaluation guidance

There are several major changes to the way the public sector carries out bid evaluation. First and foremost, procuring authorities must absorb and reflect the values of *Meeting the Investment Challenge*, for example that value for money in PFI must not come at the expense of the terms and conditions of workers or good design.

Similarly, they must incorporate the changes made in the revised Green Book, the government’s investment appraisal manual. The Green Book has been amended in a number of different areas to improve the public sector’s approach to analysing investment decisions. The discount rate has been unbundled so that it is based solely on the rate of social time preference. Specific allowance must be made for ‘optimism bias’, the demonstrated, systematic tendency for investment appraisers the world over to be overly optimistic about likely costs and timescale. These adjustments should have a sound basis in empirical evidence about inaccuracies in previous

forecasts. Further changes have also been made to take account the impact that different procurement approaches can have on the tax take and to encourage appraisers to quantify *all* of the benefits accruing from an investment.

Conclusions

The key messages from the Treasury are, first, that the timing of decision making will be changed so that it is prior to the start of procurement. Second, more formal weight should be given to judgement and the quantitative analysis placed in its proper, qualitative context. Finally, we want to embed a rigorous, evidence-based approach to decision-making in PFI.

To give these aims practical form we have made a number of changes, some of which I’ve already mentioned. First and foremost we have incorporated them into our Value for Money guidance, which will be the template for all future PFI assessment and appraisal.

Our goal is to ensure that PFI only goes ahead for value for money reasons, not balance sheet reasons, and to foster a culture of evidence-based decision making to support this goal. On the whole, feedback from the private sector, unions, and especially from the National Audit Office has been positive.

2. David Finlay, National Audit Office

Value for Money Assessment

The previous system for assessing PFI projects was problematic in a number of ways. In particular, it invariably placed emphasis on a comparison with the estimated costs of conventional procurement. It did not take account of uncertainty in how much a contract might have cost under conventional procurement, and whether these cost comparisons were relevant at the time of closing the deal. Therefore we support the Treasury’s new approach to assessing value for money in PFI projects.

The new approach will include qualitative as well as quantitative factors at both a sector and individual project level. However, once the decision to use PFI is made, the main issue

is about whether there has been strong competition, and the public sector comparator drops into the background.

There will be an issue about gathering evidence to support these investment programme assessments. The construction evidence - that PFI is generally delivering building projects on time and to the price expected by central government – is very strong, but we will need more evidence on operational experience. We have looked at a number of individual deals, and published a report last year about the operations of PFI prisons, which showed that the PFI prisons generally were doing pretty well, though with some variation. The very best prison at the moment is a PFI prison, but there are some further down the scale.

Managing PFI projects in the long-term

Two other topics which will be very important for the departments taking projects forward are: managing the relationship between the public and private sector sides, and how these projects are going to change over 25 or 30 years. These topics need to be taken into account during procurement but are often not.

In the early days of PFI there was a feeling that these topics would be looked at, and got to grips with, once the contract had been let. For a number of reasons that is a dangerous approach.

The degree to which these arrangements are successful over the long-term will depend in large part on the relationship between the public sector and private sector sides. Essentially, to make a success of these projects you need both a good contract and a good relationship; obviously problems will emerge, and the issue is whether the two sides can work through the problems successfully. We have done a report on managing relationships, and will be running workshops for individual project teams on this subject, which we think is quite important.

Knowledge transfer

Knowledge transfer is important at various levels. Within a project, the people who negotiated a deal will often move on and use that experience elsewhere, and the people who are managing the contract on a day-to-day basis will be new. You need very good knowledge transfer in that situation, more

than simply handing over a five hundred page contract and saying, “It’s all in there,” as people need to understand what the deal is all about. In addition, it is important for project teams within departments to share the knowledge they are building up.

Dealing with change

Here are some quick statistics from a survey of over 100 PFI projects that was carried out by the NAO eighteen months ago. 55% - more than half – had changed in some way or other within a couple of years. Some of these changes were minor, but others related to changes in the nature of the service delivery or the buildings: about one in five government departments or project teams had asked for additional building work, again within a couple of years.

That is not the only thing that will change. Government strategy will evolve over time, which will affect the deal while, on the private sector side, management approach and financing arrangements will change, often within a few years of contract. It is too simplistic to assume that contracts will be rigid and unchanging – they will have to embrace a whole series of changing situations – so dealing with change, though not often thought about in the procurement, is very relevant.

Conclusions

Our work has identified a number of issues and, though the work being done at the Treasury is addressing these issues, I think there are still big challenges to be faced.

3. Paul Davies, PPP Forum/ PricewaterhouseCoopers

Introduction

I will start with a downbeat story, looking at value for money on the London Underground PPP, which will make you conclude that PSCs are a waste of time, and that only qualitative analysis is important. I will then give an uplifting story, also about the Underground and the use of PSCs, to show that they can be

useful in certain contexts. Finally, I will look at how that experience feeds into the Treasury guidance, focusing on asking the questions, right at the outset: are there the private sector skills to deliver the project in question? Will there be strong competition?

Problems with the PSC

For the London Underground PPP value for money analysis was originally carried out at a time when there was still too much focus on the numeric analysis, using a PSC. At the early stage of the deal, the PSC – a 30-year plan for running the Underground – was prepared with fairly limited data on how the assets were performing, or how much they would cost to repair. The record on train performance was generally poor. Against this background, an ‘accurate’ PSC was developed for use in an environment where if a bid was one penny below the PSC it was deemed to be good value, and if one penny above, bad value. In other words, a high level of science was ascribed to the process of determining value for money which, given the data on which a PSC is based, and the Underground was not atypical in this respect, seemed over-ambitious. This has shown itself in a number of transactions, where bids were close to the PSC figure. It would mean, for instance, that a small change in interest rates just before financial close could make some deals appear bad value, irrespective of whether one believes that in practice the chosen contractor would deliver a project more efficiently than by using public sector procurement alternatives.

Two solutions were arrived at in response to this counter-intuitive ‘science’ inherent in public sector comparators.

First, was to show the PSC as a range of values rather than a single number. This moves away from the pinpoint accuracy that the PSC implied prior to this, and leads the public sector to consider where within that range a particular bid might lie and whether it is likely to offer value for money. But even expressed as a range, the PSC still reflects the subjective views of the parties compiling it. With the Underground PSC, for instance, there was a fundamental disagreement between Transport for London (TfL) and the Underground and therefore the realistic range of the PSC: the Underground’s estimates were predicated on a fairly high degree of overruns, for instance, that TfL did not think would be representative in the

future. Thus all that a range of PSCs represents is a range of preconceived prejudices. This failure has led some people to conclude that PSCs are an unnecessary part of the procurement process. In hospital procurement, for example, where we have completed a large number of acute hospital PFI transactions, it has been argued that PFI is *the* way to procure hospitals, and a PSC is not necessary- as with strong competition comes good value.

Second, has been the introduction of an optimism bias adjustment– introducing a recommended premium to add to underlying cost estimates so that PSCs are a realistic view of the true price of delivering services. Both of these innovations present new additional evaluation issues themselves.

Advantages of the PSC

The uplifting story of the London Underground PSC contains four key reasons why the PSC is valuable.

- First, you can compare the PSC with the bids at a detailed level, and judge whether the bidders understand the outputs they are required to deliver. If the cost of a particular element of a services has been costed by a bidder at a third of the price shown in the PSC, it would highlight to the public sector that they would need clear evidence to show how bidders will be successful in slashing the costs, or alternatively, it will prompt the public sector to challenge whether the costs shown will be sufficient to deliver the outputs specified.
- Second, you can identify clear mispricing. On the Tube, there was some train replacement pricing that was miles out, and we realised after a while that they were pricing the wrong thing.
- Third, and less popular with the private sector, is to exert pressure on the preferred bidders. Right until financial close, you can look at individual items and ask if they are good value; a bidder being chosen as preferred bidder does not have to mean all the individual cost items have to be accepted at their best and final offer (BAFO) price.
- Finally, compiling the PSC gives the public sector the best and most realistic view of the risks of the project. If you understand the risks in the project, you will negotiate better, and understand what the private sector are worried about.

For these reasons, I would still advocate that the public sector does always compile a PSC, but not as an exercise to determine the public sector's cost of delivering a project with the knowledge that pinpoint accuracy can be hard to achieve.

Value for Money Assessment

The recent Treasury guidance talks about three key areas that need to be considered to ensure the public sector is getting good value: viability, desirability and achievability, which are all very sensible. I would add a further area – competition – which is mentioned in the guidance, but I would stress more strongly. Evidence of strong competition is as important as considering bids against a PSC, as it is through competition that the public sector gets good value. In some cases, competition can be encouraged by the public sector: in prisons, those responsible realised there were a large number of procurements to come, and, early on, were almost selecting bidders to make sure everyone got a piece of the pie. Competition can also be tested retrospectively by comparison with similar projects, especially when there is good data on unit costs.

Going through the Treasury guidance briefly, PFI is probably value for money in projects where:

- there are large capital expenditures – something the private sector is good at
- there is private sector expertise
- you can define a service output. This is how PFI works – asking for services, not specifying assets
- it is possible to do whole life costing
- procurement costs are not disproportionate. This rules out small schemes unless they are bundled
- there is little technological change, which is why IT projects are a no-no. Something procured on an output basis might be out-of-date six months later
- you can create clear efficiency incentives, both during and after the competition.

4. Chris Wilson, 4Ps

Introduction

4Ps is the local government agency responsible for providing support on PFI, PPPs and procurement generally. We mount a large number of capacity building programmes for local government, gateway reviews of projects by independent teams for example, and provide a whole raft of procurement advice and best practice. We are implementing the Treasury's new advice and assessments, which we very much welcome, at local government level.

Value for Money Assessment

We think that it is critical to bring VFM assessment to the options appraisal stage of the decision making process – this is where local government PFI projects go wrong. We have also been pushing for the rigorous enforcement of standardised PFI contracts, and the prerequisite for the project review group to use Standardisation of PFI Contract (SoPC) guidance for quite some time. We now have specific SoPC compliant contract forms for street lighting projects, for housing, for leisure projects and for many other sectors.

We also welcome the fact that the PSC is now only to be used at the Outline Business Case stage. We would agree that the PSC is fairly esoteric, and would prefer specific benchmark costings where possible, which should be fairly easy in the housing or social services sectors. The £20 million limit will have a significant impact on local authorities, especially on social services projects, but we have the Lift programme addressing that.

There is some confusion as to exactly how local authorities link into the stage one Investment Programme Level Assessment. The principal of departments taking a strategic view, and setting out specific delivery targets is essential, but we would like to know how it would work in the context of individual local authorities, and how PFI funding is to be made available to them.

There are also issues around the existing revenue support arrangements. Revenue support is based on two components:

a 4% reducing balance element and a payment of an interest element at the statutory rate. This continues to cause major affordability difficulties for local authorities entering into PFI schemes, and is exacerbated by the fact that the existing system clearly fails to adequately cover the notional capital element of a PFI scheme, with a 4% reducing balance method able to cover 66% of the capital costs of a project over a 25-year period. The 4Ps would like the Office of the Deputy Prime Minister, HM Treasury and the Local Government Association to consider the introduction at the earliest opportunity of a new system based on an annuity approach, as has already been introduced for local authority HRA schemes.

One remaining thought: PFI is still only 15% of total capital expenditure. Are we approaching the remaining 85% with the same rigorous scrutiny that we are now applying to the PFI process?

5. General Discussion

- The private sector welcomes standardised contracts in general, as they simplify and lower the cost of bidding, though they are sometimes seen as an attempt to swing contract terms in favour of the public sector.
- Market capacity is a big issue in applying Value for Money Assessment. For big hospital sector schemes it is often hard to find two bidders, let alone five.
- Overseas investors become discouraged in markets where most contracts seem to go to a few companies: to First Group and GNER in rail, for example. Showing that the market works, private sector firms are successful, and foreign companies can even match and even surpass domestic firms is the key to encouraging bidders.
- Short, sharp procurement processes lower bidding costs, and encourage bidders.
- Geoffrey Spence was asked whether it is wise to rely on qualitative analysis and the use of competition to solve post-project problems. He replied that the Treasury is cautious on both these fronts;

competition alone cannot deliver good value, the public sector must make decisions earlier in procurement, and make sure it is better organised when it approaches the market.

- The new Treasury guidance shifts a lot of decision-making from project level to departmental level. This raises an accountability issue, and there were calls for departments to publish the evidence on which they make their decisions, and for the NAO to carry out active investigations.
- Evidence on construction projects is fairly good; that on operating projects less so. Departments could do better both in terms of collecting and publishing evidence. The first stage of VFM involves articulating decisions that were not so previously – increasing openness in itself.
- Survey evidence suggests that the majority of operating PFI schemes are working well. Where they are not, people had often become fixated on the contract, and co-operation had broken down.
- It can be difficult to spread best practice on PFI projects: the Prison Service has a central department for procuring PFI, around which new ideas can diffuse easily, but in the NHS, projects are done by individual trusts, which cannot so simply share expertise.
- There is still a feeling in the private sector that many procurers – especially in local government – underestimate the scope and complexity of PFI projects. Should 4Ps get more funding?
- From the private sector side, having a public sector client who is not well informed is not a cue to rub your hands in glee; it just means it will take six months longer. The public sector is far more mature and experienced now, and the days of cherry-picking advantageous projects seem to be over.
- Nobody has yet cracked how to secure continual value for money over a 30-year relationship. However, the same problems have always existed in the public sector, and it is even harder to benchmark there.
- One of the remaining problems lies in the nature of the civil service, and its ability to manage complex, professional outcomes, which is something Andrew Turnbull is trying to address in his reforms.

Seminar 2: developing the market in PFI contracts

27th April 2004

Attendees

Chair

Ann Rossiter, Social Market Foundation

Presentations

David Clements, Business Services Association PFI Panel

Peter Coates, Department of Health PFI Unit

James Stewart, Partnerships UK

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Philip Collins, Social Market Foundation

David Finlay, National Audit Office

Alan Gilbertson, PFI Procurement Panel

Mark Glover, Mediastrategy

Tim Gosling, IPPR

Lindsay Grist, PPP Forum

Jo Hageman, LLM

Jonathan Haslam, Jarvis

Steve Hughes, Bevan Brittan

Rachael McIlroy, TUC

Margie Jaffe, UNISON

Nick Joyce, Department of Transport

Richard Laughlin, King's College London

Charles Lloyd, PricewaterhouseCoopers

John McFall MP

Rodolfo Madrid, University of Sheffield

Paul Montague-Smith, PPP Forum

Simon Moore, Bevan Brittan

Chris Nicholson, KPMG

Ian Paterson, BT Government

Julie Pearce, Office of the Deputy Prime Minister

Brian Pomeroy, SMF Board Member

Oliver Robbins, HM Treasury

Conrad Sweming, HM Treasury

James Smyth, PricewaterhouseCoopers

Gary Sturgess, Serco

On-Yee Tai, PPP Forum

Jeff Thornton, Royal Bank of Scotland

Chris Wilson, 4Ps

James Worrton, CBI

David Worksett, Bevan Brittan

Contributions:

1. David Clements, Chairman of the Business Services Association PFI Panel

Introduction

I would like to discuss, first, a few features of the current PFI market and the direction it is likely to evolve, and then some of the problems that I think we need to address. In particular, I want to argue that encouraging new entrants to the PFI market may not be as effective as making it easier for the existing players to compete.

The PFI market

The following are prerequisites for a good market:

- a steady flow of projects is critical to maintaining competitive pressures
- familiar commercial financial structures, as the market can never operate perfectly if there is continuous tinkering
- a predictable bidding period and process and, finally,

- predictable bidding costs, which implies a reasonable success rate.

Most people realise now that unless they achieve a one in three success rate, they will not do well in PFI, as over time you have to recover the sunk costs of unsuccessful bids. This is sometimes ignored, but the public sector is always going to pay sooner or later for unsuccessful bid costs, even if it is just implicit somewhere in bidders' pricing structure.

Who are the bidders? Most PFI projects are infrastructure related, and tend to involve contractors, operators and third-party investors. Contractors bear a lot of the upfront bidding costs to deal with design, but can generate early cash in the construction period. PFI contractors actually have extremely advantageous cash flows: most have probably generated enough cash to cover their investment by the end of construction. They also get a clean exit when construction finishes, aside from warranty obligations, so PFI remains attractive to the major contractors, and they are a significant factor in creating the market.

The operators have a different perspective. They have high upfront bidding costs (although not quite as high as the contractors) and may not generate any cash until construction ends. They have a very long-term commitment, typically between 10 and 30 years, and with these commitments come risks, some of which are difficult for PFI bidders to handle. Operators are drawing back from being partners in the main PFI contract consortia and, going forward, fewer operators without links to contractors will be able to stay involved.

Lastly, there are third-party investors who have probably the lowest upfront bidding costs, because they do not have heavy design, development, or legal expenses. They have no short-term cash generation, but they are not interested in short-term cash generation - they are long-term investors. However, third-party equity is not an infinite resource. The managers of such funds spend most of their time trying to find more money, and one cannot assume that equity will always be available.

Optimal number of bidders

One theme of this seminar is how to maximise the number of

bidders for PFI projects. Focusing on the number of bidders may not necessarily lead to the right sort of competition. Lots of new bidders may not help to create a good, stable market that delivers value and competitive pricing. Typically, new entrants have tended to underprice: most of the people involved in UK Highways PFI also bid in the Irish Roads process. This saw new entrants to the market take positions on demand risk which are almost certain to lead to the disruption and ruin of the long-term project. More bidders means a lower success rate and more bid costs to be recovered. That is an irrefutable equation. Experience is also a scarce resource, so far from maximising the number, the public sector should be trying to nurture its existing pool of experienced bidders and not encourage cut-price cowboys into the marketplace.

The emerging market

Contractors and third party investors dominate the emerging shape of the market, and the increasing complexity of project structures militates against new entrants. Project directors on both sides should understand deals from top to bottom and, for example, on the massively complex London Underground project there is a sneaking suspicion that they did not. The Ministry of Defence are also running projects that are difficult to understand, raising barriers to entry and creating uncertainty. There are few firms able to bear continuously high bid costs, as unless they can generate cash relatively early on they cannot commit these costs to the balance sheet.

Finally, there is a problem of deal weariness: people saying, "I don't think I can stand another deal." The process is very wearing indeed; the complexity, and the strain of coming second will, over time, drive experienced and talented people out of the market.

2. Peter Coates, Department of Health PFI Unit

Introduction

I want to discuss the bidding process and whether that is, in

itself, reducing the appetite of bidders in the market. I will speak on the presumption that PFI needs reform even though, on most measures, it is already a success.

The successes of PFI in the Department of Health include 29 major hospitals, worth £3 billion, either built, being built or operational; 26 medium-sized schemes worth £500 million built or operational, and another 37 schemes worth £5.5bn in procurement. We believe that these hospitals would not have been built in the way they have, or in the time they have, if it was not for PFI and the private sector. Therefore, when the premise is that PFI needs to be changed, it is easy to be defensive, and argue that it is not broken and does not need fixing. A big hospital building programme is happening more quickly and successfully than at any other point in NHS history. Why work on the premise that PFI is broken? Nevertheless, on the premise that things do need to change, we must identify and address shortcomings in the system.

Problems with the PFI market

There is a danger that PFI could start to fail due to a thousand allegations, a thousand assertions, because we are unable to present an alternative story about the perceived successes or failures of PFI to the media. It is very difficult to get anything published that contradicts or produces a different picture to those, like Alyson Pollock's¹³, that appear on an almost monthly basis.

There is general private sector dissatisfaction about the level of cost they must accrue on their balance sheet in order to get deals going. How might we reduce bidding costs? We could design hospitals ourselves, and tender just the construction, but this would take away a fundamental feature of PFI: that the private sector designs hospitals and takes the risks on those designs. We could adjust the risk transfer mechanisms so that less risk is transferred to the private sector. We could adjust the payment mechanisms so that there is less risk to the private sector. We could also reorganise the way the department does PFI, having a central procurement unit rather than a small Private Finance Unit, for example, but we already have standard contracts, standard output specs, standard performance schedules, staff rotation, staff retention and consultant management. You name

¹³ See, for example, Pollock A.M., Shaoul J., Vickers N., *PFI in hospitals: a policy in search of a rationale?* British Medical Journal, 2002, No. 324: 1205-9.

it, we've tried it, and we are probably out of ideas for small changes to the system.

Possibilities for reform

What big changes could make the system more attractive to bidders, or lower barriers to entry, or improve risk profiles? One possibility would be to try and set up LIFT-type vehicles for larger schemes. LIFT is a joint venture between Partnerships UK and Department of Health. It is a true partnership in the sense that the private and public sectors both take equity in the vehicle, and it is producing results more quickly than PFI: perhaps a third less time before things are built. The first few assets built under LIFT are coming on stream this year.

Another idea would be to inject government money into industry schemes. There is now an NHS bank designed to provide funds to the NHS. A foundation trust financing facility is being set up to provide capital to NHS trusts. It would not be a radical step for government to put its own money into PFI schemes.

The final possibility is just to accept the status quo, and when contract documentation goes out, have bidders simply price it, employ neither lawyers nor clever financial advisors, and sign it. Is that too radical?

3. James Stewart, Partnerships UK

Introduction

I would like to address three issues: local autonomy versus central support, the supply in the market, and the problem of flexibility in contracts.

Local autonomy and central support

The government is gradually devolving more and more responsibility to what might be called the local public sector, meaning not just local authorities, but, for example, foundation trusts in the health sector. That can cause difficulties for PFI. There is nothing wrong with devolving responsibility for policy decisions, and letting people make their own minds up about

the specification they want, but expecting relatively small local bodies to have the skills necessary for complex forms of procurement is asking too much.

A balance is needed between the local entity and central units that, while not taking responsibility for procurement, provide local entities with support so that they can carry out their procurement better. For example, a central body can handle market management, which is very difficult for local entities. The private sector is looking for one person they can talk to about the deal flow and everything else, not 20 different local authorities. There are also some economies of scale from the centre producing standard documentation and doing R&D for particular markets. A recent example of that would be the Exemplar designs done by the DfES in the Building Schools for the Future programme¹⁴. Finally, the centre can provide a pool of expertise that can help those at the local level who are responsible; those experts come back to base, share knowledge, and work as a team. There are many ways to structure central units: an enhanced PFU, a joint venture approach, or just a group of people in the centre.

Market supply

In the supply market five years ago, every health PFI had a different combination of companies bidding. Now more established consortia have developed - there are major benefits to established businesses that bid into established markets. Therefore, the more the public sector can do to create stable markets for the private sector to respond to, the more the private sector will do to create businesses that bid into those markets, and the better things will become.

There is a lot of commentary about whether there is sufficient supply capacity to meet the future demands of PFI in this country. However, this is not the big issue. There is sufficient capacity so long as the markets are managed properly. The bigger issue is efficiency: construction inflation is still running at around 7-8% per year and, if that number were reduced by even 1% over the next 10 years, it would create huge savings. There is affordability pressure on every programme and greater efficiency in supply markets will mean more infrastructure in the future.

Linked to capacity is competition. There is intense

14 *Schools for the future – exemplar designs compendium*, Department for Education and Skills, 2003.

competition for suppliers both within the UK and also, increasingly, outside the UK. The UK market must be the most attractive to bidders or they will choose markets overseas. The great thing about the UK market is that we are ahead of the game – the default option for most suppliers in Europe is Britain.

Flexibility in contracts

Flexibility in contracts is another area of concern. The procurement phase of contracts is much talked about, but one of the great challenges is the £40 billion worth of contracts in, or approaching, operation. How to manage these contracts properly will be a new challenge for many private sector companies and public sector users. Managing change will be an issue, and some new forms of contract are being developed to accommodate greater change: there is the joint venture approach within LIFT, and a similar approach will be used in the schools programme. One aim of new forms of contract where the public and private sectors both take a stake in the delivery vehicle is to accommodate change in the future.

In summary, there will be more pressure on the public sector to deliver better programmes, and private sector companies are already being choosier. In every market where we operate, there must be somebody in the centre, proactively managing that market, and helping the local entities responsible for delivering it.

General Discussion

- Low margins in UK construction are a barrier to entry for the whole industry, not just the PFI market. High bidding costs, especially for first time bidders, also reduce market entry.
- There was debate as to whether central PFI procurement bodies imply a lack of trust in local authority procurers. There was recognition that small local entities do not procure often enough to build up experience, but concern that central support prevents them bearing responsibility for failure.
- A balance is needed between standardisation, to lower average costs, and leaving scope for innovation.
- There are capacity problems in some parts of the UK market.

However, for the 42 LIFT projects, there were 19 different preferred bidders, including several new entrants. This suggests that the main problems lie with large (£50m+) projects.

- Help with bidding costs will be of little use in encouraging bidders so long as margins in the UK market are so low.
- The emergence of secondary market funds, more focused on operating PFI projects, may reduce the weight of construction companies in PFI consortia.
- One way to address concerns about PFI would be to structure contracts so as to offer rewards for success as well as penalties for failure. The current regime not only leads to bad press, but can also demotivate staff at the PFI provider. However, it leads to issues about paying twice for what is supposed to be a standard level of service.
- It was agreed that this is a fertile area for improvement. One suggestion is that procurers renegotiate incentive payments once the project is up and running. Another is to have a qualitative inspection regime, able to give positive feedback, running alongside financial penalties as happens in the Prison Service.
- Urban regeneration and housing are difficult areas for PFI because responsibility is shared between many agencies, and it is hard to build a long-term programme that would attract bidders. Criminal justice and probation may see more use of PFI in future.
- The public sector incurs high costs when PFI contracts are renegotiated. One way to avoid this is better benchmarking, to ensure that the public sector is an informed buyer, but this does not work for large or unique projects, like an acute hospital, or Ministry of Defence helicopter simulators. A flow of future work, so bidders have incentives to behave on their existing business, is essential.
- Visibility of future work varies between sectors. Health and prisons are relatively transparent, defence far less so.
- Long-term academic studies comparing conventional and PFI procurement are needed.

Seminar 3: the future of PFI and its optimal scope

8th June 2004

Attendees

Chair

Ann Rossiter, Social Market Foundation

Presentations

Shriti Vadera, HM Treasury

This presentation was given under Chatham House Rule and therefore is not included.

Stephen Glaister, Imperial College

Jon Sawyer, Urban Catalyst

Attendees

Michael Bourke, HM Treasury

Louise Brant, Merck Sharp & Dohme

Michael Burnett, Millennium Solutions

Mark Calverley, Bevan Brittan

Neil Carmichael, JBP

Dan Corry, New Local Government Network

Stephen Dance, Partnerships UK

Philip Dobson, SMF

John Fuller, HM Treasury

Tim Gosling, IPPR

Lindsay Grist, PPP Forum

Robin Harding, SMF

Steve Hughes, Bevan Brittan

Prof Richard Laughlin, King's College

Rt. Hon. Lord MacDonald of Tradeston CBE
 Paul Montague-Smith, Bell Pottinger Public Affairs
 Nayan Panchmatia, Crossrail Project Team
 Ian Paterson, BT Government Professional Services Group
 Craig Pickering, FLA
 Emma Reddington, Serco Institute
 David Rendel MP
 Richard Ritchie, BP
 Julian Rudd-Jones, Kajima Europe
 Geoffrey Spence, HM Treasury
 Ivan Stein, Quantum, DCA
 Jeff Thornton, Royal Bank of Scotland

Contributions:

1. Professor Stephen Glaister, Imperial College

Introduction

As part of our discussion about the future of PFI, I want to address a specific question: what difference might the new prudential borrowing regime make to the development of PFI? I should make clear that I am currently a member of the Transport for London Board. I should also make clear that raising this question is not intended to be, in any way, an attack on PFI, which I believe to be useful in the right circumstances.

Prudential borrowing regime

Prudential borrowing came in last April (2004). It allows local authorities to borrow without permission to the extent that they can convince themselves that they are borrowing prudently within independently set rules. I believe this has the potential to be enormously important in helping to reinvent local authorities. However, I also believe that there is real doubt about whether that in fact will happen.

I will focus on the context of urban infrastructure since that is my subject, although there are other areas, including urban regeneration, to which this is relevant. We are talking

here about long-lived physical assets – an important special characteristic. In this area of urban infrastructure investment, the use of PFI is actually a second order issue. The first order issues are the lack of competence and dysfunction of local authorities in procurement.

There are a number of important issues to note. First is that the inability of local authorities to borrow without permission has meant, in the past, an effective inability to borrow full stop. This has now changed, as has the former inability of local authorities to raise income to repay borrowing. It is important to note that the repayment issue relates to PFI as much as any other form of procurement.

Second, it is clear that by international and historical standards we have a highly centralised system of decision-making about procurement in this country. For example, the Department of Transport is making really quite detailed decisions about what can and cannot be done; what projects can and cannot go ahead at the local level.

Third, historically I believe local authorities have felt under pressure to use PFI or PPP-type arrangements for several reasons. The perception has been, correctly or incorrectly, that they are more likely to get permission to do something if what is proposed is seen to be off balance sheet. The perception has been that PFI, in the famous phrase, has been “the only game in town.” This has led local officials, who generally do not care where the money comes from, to have proceeded with PFI projects.

Incentives for employment of PFI

The perception that PFI gives one something for nothing has been very corrosive amongst elected members, officials and even Members of Parliament. There seems to be the belief that somehow the private sector will be able to provide something that the public sector cannot afford. Of course, it's fallacious, but it is quite commonly said.

For their part, the Treasury and Department of Transport have been very keen to see PFI and PPP procurement used because of their belief in the incompetence of the local authority to procure effectively. The centre does not have the resources or the information to undertake the procurement themselves.

Therefore suggesting or insisting on PFI and PPP has seemed like a way of decentralizing good procurement practice.

Allied to this is the fact that the Treasury is very conscious that the cost of poor value for money projects, and of projects that ex-post perform badly, will fall back inevitably on the Treasury. Understandably, the Treasury has been keen to try and stop that happening. As a consequence, a vicious circle has been created, so that local authorities, having lost real accountability and discretion, have also lost their competence because there's no joy (or at least less joy) than there used to be in working the system.

Much more importantly, there is now a fundamental mismatch of incentives. Instead of local populations saying what they would regard as good value for their own money and what they would be willing to pay for, you end up with local authorities bidding for as much money as they think they can get from the centre without due regard to what it would actually be worth doing. This shifts the onus back on to the Treasury or other relevant department to apply their own appraisal criteria, instead of forcing councils and populations locally to think about what they would regard as a good way of proceeding, which may or may not accord with any central government policy.

So, the incentives to be efficient and sensible about procurement have been misaligned. In short, we have weak and unaccountable local government. I believe that that is actually by design in London, and is happening by default outside London.

There is nothing wrong with what we have in principle. We can operate the current system, but in my area of urban transport infrastructure, if we are going to develop further, there is going to have to be more on-balance sheet borrowing and more tax-funded spending to service that borrowing. At the moment, the government will not borrow any more centrally and it will not raise any more taxation centrally.

Scope for new PFI schemes

If we were to accept the current system and those constraints, we would not get any more substantial urban transport infrastructure. So, to return to my opening question: how does borrowing help to change this? I think it is pretty clear

that it does not. The ability to borrow is useless unless you have the ability to pay it back. So the picture will change if, and only if, local authorities can find new sources of local discretionary finance for which they are accountable. In other words, more local taxation. This will be possible if, and only if, central government continues not to cap local authority borrowing (and that will be hard, I imagine, for them to resist).

I think with these conditions in place, the future in my area is pretty grim. Transport infrastructure is in a pretty poor state. On the other hand, if local authorities were to acquire some more local tax raising powers, then the flood gates would be opened. Authorities will then have the opportunity to borrow to refund and to procure as they see fit. Then it seems to me that they may not choose to use PFI as a way of procuring. This is because some projects are just not suitable for PFI. They also may have perfectly legitimate local political reasons for doing procurement in a different way.

Conclusion

The crucial thing in all of this is that those making local decisions must be accountable to the local tax payer. We need to reinvent local government and to address the issue that, at the moment, the incentives are out of line. When the National Audit Office issued a report that suggested that trams may or may not be a good thing, the Secretary of State for Transport felt it necessary to make a statement about whether he thought trams were or were not a good thing. This is not the right response. This is a local matter but at the moment the burden does not fall on local politicians to make their own mind up. If prudential borrowing is to be made to work, the ability to raise local taxation will be a necessary condition, leading to much better local accountability and the reinvention of local government.

Just as important at disciplining local authorities, in this brave new world of mine, is being accountable to the financial markets. If you are to make this kind of system work, local authorities have to keep the confidence of the financial markets. You have to have a capital plan which lasts as long as the assets and you have to have convinced the market that you are going to do something sensible over a period of years –

much longer than the duration of any particular individual's time in local government.

2. Jon Sawyer, Urban Catalyst

Introduction

Those of us who are involved in regeneration work are beginning to talk about using PFI, but it is still early days, despite an increasing prevalence of mixed-use development and the involvement of some of the bigger investment houses in regeneration schemes. Unfortunately, there is still a lot of poor practice in regeneration: for example, schemes that arrive late and/or where the client brief is compromised. In addition, most regeneration focuses on urban areas – rural regeneration is still something that the industry is less familiar with. Unfortunately this means that some things that we might like to see as best practice (like the use of environmental technology and off-site manufacturing) which the government is trying to push are still far off our agenda. However, since this is not the case overseas, then it should be the case that we are capable of introducing them here.

Barriers to PFI use in regeneration

Many of the big development funders are still not involved in regeneration, which suggests that what is required is a new kind of entity (similar to urban regeneration companies or urban development corporations) in regeneration areas, to bring the public sector and the private sector together to develop PFI regeneration schemes. We also have a real issue around delays in the system: decisions can sit around with local authorities and other public sector parties waiting to be endorsed for long periods. But it is not just a capacity issues; there is also genuine skills issue. For example, we have a £40 million development scheme (mixed use) in a deprived area in London. The local authority concerned got their compulsory purchase order wrong three times before we put it into private sector hands. Those are the sorts of things that are putting back regeneration projects by not months but actually by years, and which do not

bode well for the introduction of PFI into the sector. The government has set itself a £22 billion challenge with its sustainable communities agenda, for example to deliver 71,000 new homes in Milton Keynes by 2031. That will require a lot more regeneration activity than the sector is capable of delivering today by a broader group of people working to different rules. This is the challenge.

Developing the regeneration sector to meet the PFI challenge

Where does the sector need to be if we are to meet that agenda? First we need to generate large schemes like King's Cross, or Barking Reach which involves 11,000 homes. The average development of a UK house builder is only 75 units at the moment, which is shockingly low when you consider what we need to build. So we need larger schemes. However, they do not need to be individual schemes - packaging elements up is one option. An example of this kind of approach is the Isis Fund: the British Waterways regeneration fund. Its portfolio incorporated ten sites all over the country, a total development of around £350 million, the size of which did engage the investment market. This is an example of the kind of approach we need to make regeneration mainstream. This requires a long-term approach - it takes twenty years to fully regenerate an area.

How do we get to that position? In part we do the things we're already doing. We disseminate good practice; we make sure that the market is aware of the returns one can get from regeneration. One option is to include set financial returns from the development of deprived areas so that these can compete with commercial ones. We also need to see the £300 billion of public sector assets played into regeneration. They should not be regarded as something for local authorities to package off and sell to the private sector to solve their immediate capital receipts needs.

The role of PFI in regeneration

Turning to PFI, it is not PFI in its purest sense which will provide funds for regeneration, but rather a variant model of PFI. The reasons for this lie in the nature of regeneration

schemes. Regeneration tends to have a strong public sector lead and tends to be uncertain (there are a lot of risks involved in land assembly, getting planning consent and getting communities on board). Those risks are poorly defined – we very rarely sit and actually cost them. We tend to start from reinventing the model every time. We tend not to go back to what actually works.

Traditionally PFI has had a contrasting set of characteristics. PFI tends to require a private sector lead, with private sector skills to be harnessed working with the public sector, and long term deals. There are examples of where this can work, for example Chatterley Valley, a big science park development in Stoke on Trent, coming through the compulsory purchase process. It will take about £20 million to acquire all of the private sector land interests and to make it an attractive area for people to invest. But once this has been done, developers will be prepared to become involved in the scheme. However, the total value of the land will be around £16 million – the gap of £4 million represents the regeneration challenge.

What PFI could bring to the scheme is the ability to bridge that gap – the ability to spread out payment for a scheme over, for example, twenty years rather than three which is currently the case. Given the scale of the scheme and its significance, it is likely to be of interest to developers and investors. However, it will require a new approach to PFI since it will not follow the typical model for, for example, a hospital where you have a designer, builder, financier and an operator. But actually there's still potential to involve the private sector in a big way.

Conclusion

The regeneration community now knows much more about PFI and has an understanding of where it does and does not work. Developments on the public sector side are also encouraging: we are getting to the position where we can really talk about joined up government. We are also getting to a position where we can start to flex the PFI model and to think about it in new sectors dealing with different challenges. But from a regeneration perspective, we need to remember that the driving force is the development of homes for people and offices for jobs, rather

than just homes and offices. It is important to remember the human element. We need to pilot PFI regeneration schemes and learn from what will and what will not work.

General Discussion:

- There is still a degree of confusion about the difference between cost and value in the public discussion about PFI. This is a case that all involved will have to continue to make.
- The fact that there are certain areas for which PFI is not appropriate is not likely to change in the future. These areas include clinical services and IT projects. This is not only because IT developments move too quickly for PFI but also because the degree of flexibility required is too great to be readily incorporated into a PFI contract.
- PFI is useful for school and hospitals despite the fact that requirements may change – there will have to be later changes *however* those facilities are financed.
- There will be failure in any kind of procurement, including PFI. The important issue is what is learnt from that, and how government responds. Failure should be allowed in order to promote accountability.
- An issue that the market is not clear about is the circumstances under which government will allow failure to happen, and whether certain projects are regarded as effectively guaranteed. It is a problem that PFI is seen as a free good since companies will bid for everything and not properly account for the risk of failure.
- The use of PFI in future, more complex circumstances, such as regeneration, raises new issues, particularly that of dealing with complexity, since complexity tends to raise costs.

Conclusions

There were a number of areas of common agreement which emerged from the discussions over the course of the three seminars:

1. Distinguishing between the cost and the value of project still bedevils the debate about the use of PFI, although there seems to be little evidence that this is true for parties to the procurement process. This confusion is unhelpful as it distracts attention away from more substantive issues about the use and future of the Private Financial Initiative.
2. The Treasury's new guidance on Value for Money Assessment was welcomed. In particular, earlier decision-making at the strategic level, and the introduction of qualitative assessment to decision-making received praise.
3. An evidence-based approach to decision-making is vital. Many speakers wanted more evidence on performance and costs, to justify, and improve, existing and future PFI projects; construction evidence is adequate, but more operating evidence would be valuable. Publication of evidence should be encouraged.
4. There is still a role for the PSC. However, a precise estimate is of little use; instead, it should inform the qualitative assessment of projects. The Outline Business Case is the correct stage at which to use the PSC.
5. Managing ongoing PFI projects over a 20 or 30-year term emerged as the greatest unsolved problem:

- greater attention should be paid to long-term management at the strategic and procurement stages
- the contract is not the way to address long-term relationship management. Instead, good knowledge transfer, mutual understanding of needs, and trust between the parties need attention
- failure to adapt in the long-term is a problem for public sector institutions, as well as those provided through PFI.

6. Competition is crucial to getting value for money, but is not always practical, especially for large schemes:

- a stable market, and visibly successful private sector firms encourage bidders, which should take precedence over encouraging competition in the short-term
- a short, sharp procurement process lowers bidding costs, and encourages competitors
- competition alone is not the answer. Procurers need to be well organised, and have a clear idea of what is good value
- in some cases, by making clear that a large procurement program will follow for example, market capacity can be built, the potential for future work attracting new entrants.

7. The discussions indicated a number of problems in spreading best practice across the public sector:

- procuring schools, hospitals, railways and prisons involves different bidders and different public services
- some procurers – e.g. local authorities and NHS Trusts – are fragmented, making it harder to share expertise.

8. Participants from both the public and private sectors felt PFI procurement is much improved since the mid-1990s. The most pressing need now is to ensure better management and greater adaptability once projects are underway.

9. A number of factors were identified as important to ensure a long-term, stable and competitive market for PFI:

- cultivating existing bidders is important. Not only do they have established skills, but the possibility of future business encourages good performance on existing contracts

- a visible pipeline of future work is crucial in maintaining competitive pressure on bidders. More could be done to ensure this, especially in sectors like defence.

10. Bidding costs are not the only barrier to entry in PFI. Sizeable economies of scale, entrenched competitors, and generally low margins in UK construction are at least as much of a problem.

11. The right balance must be struck between giving local authorities responsibility for their procurement, and supporting them when they lack the necessary skills.

12. Extending the use of PFI by local government is hindered by the inability of local government to raise its own finance, despite the new prudential borrowing regime.

13. The structure of PFI contracts, with penalties for failure and not rewards for success, is one cause of the negative publicity that dogs them. Participants suggested qualitative assessment of performance, and contract renegotiation in the operational phase to address this problem.

14. Possible methods of reducing bidding costs were:

- more LIFT-style partnerships, with shorter procurement times
- increased standardisation of contracts
- simpler structures
- fewer small PFI deals, where bidding costs are a high percentage of the total.

15. Shortages of capable suppliers might be addressed by:

- partnerships like LIFT, needing less private sector equity
- direct government equity investment in PFI schemes
- stable markets attractive to bidders
- measures to make the U.K. construction industry in general appeal to international suppliers

- transparency about the pipeline of future work.

16. Evidence is relatively thin at present on the long-term performance of PFI schemes. This is something that should be monitored and regularly evaluated.

17. Government's response to failure on the part of PFI schemes has yet to be tested. This is of concern to the market, since it raises questions over the correct assessment and allocation of risk. The government should be willing to allow the failure of PFI projects, while ensuring the delivery of core public services.

18. While PFI has the potential to facilitate the government's regeneration objectives, there are a number of barriers to its use, including the readiness of the regeneration sector to manage PFI projects, and the requirement to manage the complexity inherent in such projects without driving up bid and management costs.

Glossary

Best and Final Offer (BAFO)

Best and Final Offer is the final priced bid submitted by bidders following evaluation and negotiation of initial bids.

Investment Programme Assessment

The Investment Programme Assessment is the first stage of the Value for Money process. It involves a meticulous appraisal of project suitability based on the Government's assessment of similar projects already undertaken through the PFI in the sector and whether the PFI process takes into account wider procurement policy through "equity, efficiency and accountability."

Local Improvement Finance Trusts (LIFT)

The Local Improvement Finance Trust initiative is the vehicle with which the Government intends to enhance primary and community healthcare by creating a strategic partnering arrangement between the private sector and NHS participants.

Outline Business Case (OBC)

The Outline Business Case is prepared by the procuring authority to establish the need for the project, and consists of an option appraisal and a business plan defining the required objective and outputs of the project/and how these can be realised.

Private Finance Initiative (PFI)

Introduced by the Conservative government in 1992, and retained by the Labour Government in 1997, as a way of generating new investment in public services without raising taxes. When companies enter into a PFI agreement, they agree to build large-scale capital projects, such as hospitals

and schools, and lease them back to the public sector over a period of 30 years or more.

Private Finance Unit (PFU)

The Private Finance Unit is responsible for developing and promoting PFI policy for public bodies.

Project Assessment

Project Assessment is the second stage of the Value for Money process. Here, the final amendments are made to the public sector comparator prior to procurement.

Public Private Partnership (PPP)

Public Private Partnership is the generic term for projects involving both the public and private sectors. The involvement can be to varying degrees and the partnership can take different forms.

Public Sector Comparator (PSC)

The Public Sector Comparator is a benchmark used in the course of procurement against which the value for money of bids is assessed by the public partner. It represents a notional cost estimate of the project based on the assumption that the facilities and services which are the subject of the project are procured through traditional means with the public partner retaining managerial responsibility and exposure to risk.

Ryrie Rules

The Ryrie rules, which operated during the 1980s, insisted that privately financed projects could only proceed if they offered better value for money than a hypothetical public sector 'comparator', even if budget constraints meant that the public sector alternative would not go ahead.

Standardisation of PFI Contract (SoPC)

The Standardisation of PFI Contracts was first published in July 1999 with the aim of providing guidance on the key issues that arise in PFI projects in order to promote the achievement of commercially balanced contracts, and enable public sector procurers to meet their requirements and deliver best value for money.

Value for Money (VFM) guidance

Value for Money guidance is one of the key requirements a PPP project must meet. It must be able to be demonstrated, through the Public Sector Comparator, that the PPP option represents the most effective method of delivering the output specification at the most affordable cost.

The Private Finance Initiative is out of its infancy, but is far from maturity. While policymakers have a far more sophisticated understanding of the factors influencing success of PFI projects during their initial construction phase, it is the management of PFI projects over their 20 to 30 year life times that now presents the greatest challenge.

This paper is based on a series of roundtable seminars held at the Social Market Foundation during 2004, during which the major issues facing the on-going management and use of PFI procurement were discussed. These included how procurement practices might be improved and better value for money obtained by the taxpayer and how the market for PFI bidders might be fostered. The paper also looks ahead at the future and optimal scope of PFI.

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