CONCEPT AND BACKGROUND TO PUBLIC PRIVATE PARTNERSHIP (PPP) / PRIVATE FINANCE INITIATIVE (PFI)

UK EXPERIENCE

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INTRODUCTION

PFI (Private Finance Initiative) is a public service delivery type of PPP (Public Private Partnership) where the responsibility for providing public services is transferred from the public to the private sector for a considerable period of time. PFI, which is considered as a generic classifier for all types of ‘construction’ PPP, is also a means of using private finance and skills to deliver capital investment projects traditionally provided by the public sector. It is essentially the same thing as DBFO (Design, Build, Finance, Operate), DCMF (Design, Construct, Manage, and Finance), BOO (Build, Own and Operate), BOT (Build, Operate and Transfer), and BOOT (Build, Own, Operate and Transfer).

Globally, the movement towards PFI procurement methods was driven by the need to fund infrastructure projects and/or the need for private sector innovation in the design and management of public sector facilities and infrastructure projects\(^1\). In developing countries, the high demand for infrastructure development, coupled with the pressures on national budgets, is making governments move towards encouraging the private sector to invest in infrastructure projects.

In PFI projects, the private sector develops, finances and maintains an asset used in the delivery of public services. In return, the public sector pays a monthly charge that covers both the repayment of the capital investment and the ongoing service costs. This transforms government departments from being owners and operators of assets into the purchasers of services from the private sector. The key principles of PFI are:

- Purchase services not assets
- Value for money to the public sector
- Project risk management between public and private sectors
- Utilizing and incorporating private sector know-how and expertise; and
- Incorporating whole life-cycle costing in infrastructure projects

The PFI market is limited to large size contractors. A survey shows that only 15% of construction cost and 13.20% of the operation Net Present Value (NPV) cost of the fifty-three PFI projects they surveyed are less than £10 million (Bing \textit{et al.}, 2005). This type of contracts demand special financial and managerial requirements which add significant complexity to relationships between the concerned parties,

\(^1\) Infrastructure is defined as transportation infrastructure (roads, bridges, airports, ports, rail lines); communications infrastructure; housing; and electricity generation and distribution. Infrastructure projects can be “mega projects” (dams, coast-to-coast highways, mega-ports, large power plants) or much smaller projects that can include communication franchises or limited highway spurs.
negotiation, arrangements, agreements, and long-term engagement. This implies that small and medium contractors are not capable of dealing with the complexity and size of PFI projects.

**PFI VS TRADITIONAL PROCUREMENT**

The Construction Industry has been criticized for its fragmented process which is a major weakness for its poor performance. In a major review report on the performance of the industry in the UK described the fragmented nature of construction project processes as a fundamental malaise infecting the industry (Egan, 1998). Separation in responsibilities and work teams between design, finance, construction and operation of the building and the running of the facilities assets was one of the main reasons for failure or lack of performance in many construction projects.

In PFI projects, design and construction become fully integrated up-front with operations and asset management. Ongoing service delivery, operational, maintenance and refurbishment costs become a single party’s responsibility for the length of the concession period;

In this context, the bidding cost in PFI projects is considerably higher. Both the public and private sectors are required to hire technical, legal, and financial consultancies to ensure the project’s affordability and Value for Money (VfM) for the public sector, profitability, bidding quality etc. The bidding and advisory costs to both the private and public sectors are high and could range from £0.1-2.0 million, depending on project type and size. This risk is considered to be high as if the client awards the project contract to a competitor or does not award it at all, the contractor will not be compensated for their bidding cost.

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Figure 1: The difference in public payments between PFI & Traditional Procurements
In addition, a distinguishing feature of the PFI procurement is the timing of responsibility and payments, Figure 1. The public sector procurer does not pay capital over the construction period, but rather pays for the service during the operational period. The private sector, on the other hand, pays the capital cost, which it recoups through the service payments. The public sector does not take responsibility for the design of project but rather it specifies its services by way of an output specification. Additionally, the public sector operator no longer operates the asset but rather monitors service delivery and performance. Table 1 shows differences between PFI and traditional procurements.

<table>
<thead>
<tr>
<th>Area of consideration</th>
<th>Characteristics of traditional public sector procurement (generalized)</th>
<th>Characteristics of the Private Finance Initiative (generalized)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duration of private sector involvement in the project</td>
<td>Until construction of the facility is complete (plus the defects liability period)</td>
<td>Normally for at least 25 years for construction-related PFI projects</td>
</tr>
<tr>
<td>Specific company involvement</td>
<td>Appointed by the public sector client on an individual basis for the supply of specific skills</td>
<td>Involved as part of a concessionaire consortium with all the skills necessary or taking a key supply contracting role, being appointed by the bidding firm or concessionaire</td>
</tr>
<tr>
<td>Private sector risks</td>
<td>Specific to the area of involvement and limited to defect liabilities</td>
<td>Wide ranging and long term</td>
</tr>
<tr>
<td>Remuneration</td>
<td>Lump sum or percentage fee</td>
<td>Annualized payment</td>
</tr>
<tr>
<td>Opportunity for private sector to suggest improvements</td>
<td>Limited</td>
<td>Considerable</td>
</tr>
<tr>
<td>Key financial consideration for private sector company</td>
<td>Maintaining a positive cash flow and margins</td>
<td>Having an adequate asset base and debt facility</td>
</tr>
<tr>
<td>Attitude required of the private sector from the public sector</td>
<td>Maintaining a positive cash flow and margins</td>
<td>Maintaining a positive cash flow and margins</td>
</tr>
<tr>
<td>Responsibility for design, build, finance and operate</td>
<td>Lies with the public sector procurer</td>
<td>Lies with the private sector concessionaire</td>
</tr>
<tr>
<td>Accountability for the resulting services</td>
<td>Public sector procurer is accountable to itself/Parliament</td>
<td>The private sector concessionaire is accountable to the public sector procurer who in turn remains accountable to parliament for the services provided</td>
</tr>
</tbody>
</table>

Table 1: Differences between PFI and traditional procurement
(Source: Ahadzi and Bowles, 2001)
PFI PARTIES

PFI projects typically comprise three main parties, as follows:

- The Awarding Authority: this is the public sector client responsible for procuring the project. It may be a central government department, local authority, or government agency.
- The Special Purpose Vehicle (SPV): A limited company (i.e. the project consortium) that is set up for the sole purpose of delivering the PFI project. It is responsible for the project from the start to the end of the contract, which normally spans more than twenty years. It acts as the management and operating company for the project, and is the legal owner of the concession that is granted by the public sector.
- Third-party funders: such as equity, bank loans, or bonds.

TRANSFERRING RISK TO THE PRIVATE SECTOR

Construction is a process governed by complicated contracts and involving complex relationships across several tiers, and there are many risks involved in construction projects. A risk is seen as the uncertain possibility of something happening in the future. It concerns potential problems, i.e. the possibility of something going wrong that can result in increased cost or cause delay. In PFI procurement, it is a fundamental requirement that appropriate risks are transferred to the private sector, or allocated to the party that is best able to manage the risk in a cost-effective manner.

The UK Treasury Taskforce defined risk types in PFI projects as shown in Table 2.

PFI - VALUE FOR MONEY

PFI should only be pursued where it delivers value for money (VfM), where VfM is the optimum combination of whole life cost and quality to meet the user’s requirement. The base line for this judgment is the economic comparison with how a particular project is delivered on a PFI procurement over its whole life (typically 20-25 years), and how it could be provided if public sector funds were available.

In order to ensure that the public sector procurement delivers the best Value for Money, it requires that public service clients should ensure that:
### Table 2: Risk Types in PFI Projects

<table>
<thead>
<tr>
<th>Availability risk</th>
<th>The risk that the quantum of the service provided is less than required under the contract.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction risk</td>
<td>The risk that the construction of the physical asset is not completed on time, to budget and to specification.</td>
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<tr>
<td>Decant risk</td>
<td>The risk arising in accommodation projects relating to the need to decant staff/clients from one site to another.</td>
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<tr>
<td>Demand risk</td>
<td>The risk that demand for the service does not match the levels planned, projected or assumed. As the demand for a service may be (partially) controllable by the government, the risk to the public sector may be less than that perceived by the private sector.</td>
</tr>
<tr>
<td>Design risk</td>
<td>The risk that the design cannot deliver the services at the required performance or quality standards.</td>
</tr>
<tr>
<td>Inflation risk</td>
<td>The risk that actual inflation differs from assumed inflation rates.</td>
</tr>
<tr>
<td>Legislative risk</td>
<td>The risk that change in legislation increases costs. This can be sub-divided into general risks such as changes in corporate tax rates and specific ones, which may discriminate against PFI projects.</td>
</tr>
<tr>
<td>Maintenance risk</td>
<td>The risk that the costs of keeping the asset in good condition vary from budget.</td>
</tr>
<tr>
<td>Occupancy risk</td>
<td>The risk that a property will remain untenant – a form of demand risk.</td>
</tr>
<tr>
<td>Operational risk</td>
<td>The risk that operating costs vary from budget, that the performance standards slip or the service cannot be provided.</td>
</tr>
<tr>
<td>Planning risk</td>
<td>The risk that the implementation of a project fails to achieve the terms of planning permission, or that detailed planning permission cannot be obtained, or, if obtained, can only be implemented at costs greater than in the original budget.</td>
</tr>
<tr>
<td>Policy risk</td>
<td>The risk of changes in policy direction not involving legislation.</td>
</tr>
<tr>
<td>Residual value risk</td>
<td>The risk relating to the uncertainty of the value of physical asset at the end of the contract period.</td>
</tr>
<tr>
<td>Technology risk</td>
<td>The risk that changes in technology result in services being provided using non-optimal technology.</td>
</tr>
<tr>
<td>Usage risk</td>
<td>The risk that actual usage of the service varies from the level forecast.</td>
</tr>
</tbody>
</table>

- Projects are awarded in a competitive environment
- Economic appraisal techniques, including a proper appreciation of risk, are applied rigorously
- Risk is allocated between the public and private sector so that the expected VfM of the services provided to the public is maximized, and
- Comparisons made between publicly and privately financed options are fair, realistic and comprehensive.

The New South Wales Government’s guidelines for Privately Financed Projects (NSWG, 2001) listed the major value-for-money drivers as:
• Improved risk management — more rigorous risk evaluation and transfer to the private sector of those risks it is best able to manage;
• Ownership and whole-of-life costing efficiency is improved because design and construction become fully integrated up-front with operations and asset management. Ongoing service delivery, operational, maintenance and refurbishment costs become a single party’s responsibility for the length of the concession period;
• Innovation — wider opportunities and incentives for innovative solutions to deliver services requirements; and
• Asset utilization — reducing cost to government, as a sole user, through more efficient design to meet performance specifications and by creating complementary opportunities to generate revenue from use of the asset by others.

THE DISADVANTAGES OF PFI PROJECTS

It is clear from what was stated earlier that PFI contributes to the improvement of public services and infrastructure projects; however, like other procurement systems, PFI has not been a total success. There are no comparisons in the statistics to show the percentage of project failure and the effects of some of the disadvantages associated with PFI on public projects or the end users. Some problems reported with PFI procurements (Akintoye et al. 2001), such as:

• High costs are used to tender PFI projects;
• Agreements are brought about through complex negotiations;
• Innovation inputs, in both design and construction, could be inhibited, as contractors become wary of overruns;
• The information of project consortia (SPVs) can be difficult as constituent members have differing objectives;
• There are disparity problems between the private and public sector, in terms of differing modes of operations, decision making and accountability;
• The attitude of government, supportive or otherwise, can ease or complicate the problems;
• The cost of finance is quite high, given that governments can borrow money more cheaply than private firms.

REFERENCES


