

## **The United Kingdom Private Finance Initiative: The Challenge of Allocating Risk**

*by*

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*Since 1992, the United Kingdom has used a new type of public-private partnership for the delivery of public services: the Private Finance Initiative. In the design of PFI projects, the assessment of risk, and who is best able to manage it, needs to be carefully considered. Using data from government reports and case examples in the British public sector, this article explores aspects of procurement including, among other things, due diligence, public sector comparators, and the consequences of taking back the responsibility for delivering the service (taking back risk). PFI contracts can deliver better value for money than traditional methods of procurement if risks are transferred to the parties best able to handle them. The article concludes with a discussion of guidelines on generally accepted accounting practice and indicators for assessing risk.*

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## 1. Introduction

The United Kingdom (UK) has been at the forefront of the development of innovative approaches to engaging the private sector in the delivery of public services. In 1992 the UK embarked upon a new type of public-private partnership, known as the Private Finance Initiative (PFI). Under the Private Finance Initiative, private sector firms take on the responsibility for providing a public service including maintaining, enhancing or constructing the necessary infrastructure required. A total of 563 Private Finance Initiative contracts had been let by April 2003, with a total capital value of £35.5 billion (HM Treasury, 2002-3), and accounting for more than ten per cent of total investment in the UK public sector in 2003-4.

This article explores the value for money of the Private Finance Initiative. It argues that there are powerful performance incentives in Private Finance Initiative contracts which at least potentially offer significant improved performance compared to past practices. It suggests that Private Finance Initiative contracts enable risks to be better estimated than in the past, but that the real success of Private Finance Initiative projects also depends on the degree to which risk is genuinely transferred from the public to the private sector and optimally shared. It also considers some of the difficulties this presents for accounting for Private Finance Initiative projects. It draws on the work of the United Kingdom National Audit Office and the House of Commons Committee of Public Accounts which have both examined and reported to the United Kingdom Parliament in detail on a number of individual Private Finance Initiative projects as well as other general issues arising from the initiative.<sup>1</sup>

## 2. Risk under conventional procurement in the public sector

Public service delivery is a risky business. The operation of any organisation, public or private, involves risk. But public service agencies operate across a diverse range of activities, markets and locations. Many of the projects they have responsibility for delivering are large or unique. They may not have precedents on which to draw to help guide implementation. And they are usually more exposed to political and reputational risk. Despite this it is only in the last ten years, that public sector policy makers and implementers have turned their attention in earnest to risk management techniques.

Effective risk management involves anticipating, preparing for, and mitigating adverse outcomes, without eradicating, or unnecessarily

hindering, beneficial risk taking. Well managed risk taking also presents opportunities to innovate, experiment and develop new ideas where more traditional ways of working are not able to deliver real change; for example, in providing an environment where radically new or different approaches can be developed in the confidence that the associated risks will be well managed. Indeed the greatest risk of all may be not taking any risks, where services and the way they are delivered do not anticipate change or evolve to meet new demands from citizens.

Constructing and operating a public building entails a number of risks. These include the risk of construction overruns, higher than expected costs of maintenance, increases or decreases in demand for the services provided in the facility, and changes in legislation or the regulatory regime affecting how the building or the services it houses are delivered. In a traditional construction contract the public sector has accommodated a number of types of risk: design and construction risk – delivering to cost and time; commissioning and operating risks – including maintenance; demand (or volume/usage) risks; residual value risk; technology and obsolescence risks; regulation and similar risks (including taxation, planning permission); and project financing risk.

For each project, some risks are more relevant than others. In a road project, the key risks will be demand and design/asset construction and maintenance, whereas in a prison project, the key risks relate to availability, performance and operating costs alongside design/asset construction and maintenance.

The record of conventional public sector procurement in assessing these risks is not good. The full costs of projects have often not been calculated accurately beforehand, risk management procedures have often been weak and there have been insufficient incentives to ensure that projects are driven forward successfully. Recent examples in the UK include the following:

- The initial cost estimates of Guy's and St Thomas's Hospital rose by £124 million to £160 million and the completion date slipped by over three years (NAO, 1997-8b);
- The cost of the Trident submarine shiplift and berth at Faslane rose from an estimate of £100 million to a final cost of £314 million and was delivered two and a half years late (NAO, 1993-4);
- The London Underground Jubilee Line extension was delivered two years late and cost £1.4 billion more than original estimates; and

- The top 25 equipment projects in the Ministry of Defence experienced cost overruns amounting to £2.8 billion with average delays of three and a half years (NAO, 2003-4).

A recent National Audit Office study found that only 30 per cent of conventional procurement construction projects were delivered on time and only 27 per cent were within budget (NAO, 2001-2a). An independent report commissioned by the Treasury found that outturn costs of conventional procurement construction projects were between 2 and 24 per cent higher than the estimate in the business case (HM Treasury, 2002).

### **3. What is the Private Finance Initiative?**

Under conventional procurement, the government typically enters into one contract with a builder to develop a government-designed asset and then either operates this itself or enters into a second contract for operation. A common problem is that the operator or service provider, having no role in the design and construction stages, finds that the asset has been designed or built in a way that limits flexibility when it comes to delivering services more efficiently. This often results in substantial operating cost implications over the typical 25-30 year life of the asset.

The Private Finance Initiative is a form of public-private partnership that combines procurement, where the public sector purchases capital items from the private sector, with an extension of contracting-out, where public services are contracted from the private sector. It differs from privatisation in that the public sector retains a substantial role as the main purchaser of services or as the enabler of the project. It also differs from contracting out since the private sector provides the capital asset as well as the services. A Private Finance Initiative contract is intended to provide a continuing commercial incentive for synergy, flexibility and efficiency right through from initial design, build and operation.

Under the most common form of Private Finance Initiative, the private sector designs, builds finances and operates facilities based on specifications of outputs determined by public sector bodies. The requirements of the public service body would normally be framed not as precise input specifications and designs, but as an output specification defining the service required; for example supporting hospital beds for a certain number of patients, or prison accommodation for a specific category of inmates. Under a Private Finance Initiative contract the public body usually pays a stream of committed revenue payments for the use of the facilities over the contract period. Once the contract has expired, ownership of the asset may

remain with the private sector contractor or pass to the public sector, depending on the terms of the contract.

For example, in 1999 the Ministry of Defence identified that improvements were necessary to the accommodation and working environment available in its principal office building and decided to redevelop it. This was a large and complex project. It involved moving over 3 000 staff into other central London accommodation, carrying out an extensive redevelopment, disposing of surplus properties and then moving staff back into the redeveloped building. In May 2000, the Ministry of Defence let a Private Finance Initiative contract with a net present value of £746 million (at 2000 price levels) to a private sector consortium called Modus. The 30-year contract covered the redevelopment and limited refurbishment and provision of support to other buildings needed to accommodate staff while redevelopment was undertaken, followed by the provision of maintenance and facilities management services (NAO, 2002-3).

Private Finance Initiative deals have ranged from very small projects, such as a £100 000 scheme to improve information technology facilities at a local school, to Europe's largest construction project – the Channel Tunnel Rail Link, worth £4 billion (NAO, 2000-1b). Private Finance Initiative contracts have been signed in over twenty different sectors and by over one hundred different public sector organisations within central and local government and the National Health Service. The largest users of Private Finance Initiative have been the Department for Transport which accounts for about 20 per cent of all Private Finance Initiative projects by capital value and the Department of Health which has signed about 120 separate Private Finance Initiative contracts (HM Treasury, 2002-3).

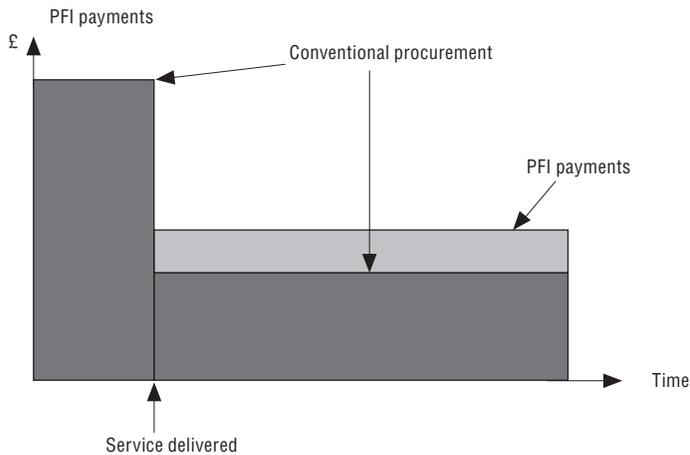
The UK's Treasury has stated that one of the main objectives of Private Finance Initiative is to transform public sector bodies from being owners and operators of assets into purchasers of services from the private sector. Private firms become long term providers of services rather than simply upfront asset builders, combining the responsibilities of designing, building, financing and operating the assets in order to deliver the services demanded by the public sector (*ibid.*).

#### **4. The potential advantages and disadvantages of Private Finance Initiative deals**

Private Finance Initiative contracts are generally long term arrangements involving public expenditure over extended periods, often for 30 years or more. The public sector does not have to find the money up-front to meet

the initial capital costs. But the cash payments thereafter will generally be higher than in an equivalent conventionally-financed project (Figure 1).

**Figure 1. Timing of payments under the Private Finance Initiative and conventional procurement**



Source: Public Accounts Committee (2003).

The Private Finance Initiative approach can enable the public sector to undertake projects which they would be unable to finance conventionally since they do not need to find all the money for the capital asset during its construction. Private Finance Initiative deals can therefore be attractive in the short term. But there is a risk that this attractiveness may distort priorities in favour of those projects which are capable of being run as Private Finance Initiative projects. For the Private Finance Initiative route to be worthwhile, the higher financing costs of raising funds in private markets and any other potential disadvantages need to be more than outweighed by the benefits achieved. Some of the potential advantages and disadvantages of Private Finance Initiative deals are set out in Table 1.

## 5. The public sector versus private sector decision

Up until recently the main tool public bodies have relied on in evaluating up-front whether a Private Finance Initiative option provides better value for money over conventional procurement is a public sector comparator. A public sector comparator is a costing of a conventionally

financed project delivering the same outputs as those of the Private Finance Initiative deal under examination.

**Table 1. Potential advantages and disadvantages of Private Finance Initiative deals**

Advantages	Disadvantages
<p>There can be greater price certainty. The public sector body and contractor agree the annual unitary payment for the services to be provided. This should usually only change as a result of agreed circumstances.</p>	<p>The public sector body is tied into a long-term contract (often around 30 years). Business needs change over time so there is the risk that the contract may become unsuitable for these changing needs during the contract life.</p>
<p>Responsibility for assets is transferred to the contractor. The public sector body is not involved in providing services which may not be part of its core business.</p>	<p>Variations may be needed as the public sector body's business needs change. Management of these may require renegotiation of contract terms and prices.</p>
<p>Private Finance Initiative brings the scope for innovation in service delivery. The contractor has incentives to introduce innovative ways to meet the public sector body's needs.</p>	<p>There could be disadvantages, for example, if innovative methods of service delivery lead to a decrease in the level or quality of service.</p>
<p>Often, the unitary payment will not start until, for example, the building is operational, so the contractor has incentives to encourage timely delivery of quality service.</p>	<p>The unitary payment will include charges for the contractor's acceptance of risks, such as construction and service delivery risks, which may not materialise.</p>
<p>The contract provides greater incentives to manage risks over the life of the contract than under traditional procurement. A reduced level or quality of service would lead to compensation paid to the public sector body.</p>	<p>There is the possibility that the contractor may not manage transferred risks well. Or public sector bodies may believe they have transferred core business risks, which ultimately remain with them.</p>
<p>A long-term Private Finance Initiative contract encourages the contractor and the public sector body to consider costs over the whole life of the contract, rather than considering the construction and operational periods separately. This can lead to efficiencies through synergies between design and construction and its later operation and maintenance. The contractor takes the risk of getting the design and construction wrong.</p>	<p>The whole life costs will be paid through the unitary payment, which will be based on the contractor arranging financing at commercial rates which tend to be higher than government borrowing rates.</p>

Source: Public Accounts Committee (2003).

The use of public sector comparators has been the subject of considerable debate. The accuracy of public sector comparators is limited because they are prone to error owing to the complexity of the financial modelling that is often used. They are also dependent on uncertain forecasts. And a great deal depends on assumptions about the time cost of money – *i.e.* the discount rate.

There is a risk that the users of the public sector comparator will believe that it is more accurate than it could ever be. Decisions can be made on the basis of small and spurious differences between the public sector comparator and the Private Finance Initiative option. In the case of the Private Finance Initiative contract for a new accommodation programme at the Government Communication Headquarters, the management made a highly uncertain assumption that a conventionally procured building would have overrun its budget by 24 per cent. That alone accounted for the comparative cost saving that the Government Communications Headquarters estimated the Private Finance Initiative deal would offer, but was simply an average over past projects and hid the wide range of possible outcomes (Public Accounts Committee, 2004-5).

The UK House of Commons Committee of Public Accounts believes there have been many cases where the public sector comparator has been incorrectly used as a pass or fail test. In these cases the desire to show that the Private Finance Initiative deal is “cheaper” than the public sector comparator has led to manipulation of the underlying calculations and erroneous interpretation of the results (Table 2). There are likely to be qualitative and non-financial differences between the options that cannot simply be subsumed in a difference in forecast cost. The UK Treasury has recently recognised this and instituted reform of the public sector comparator as only a single element within an approach which is intended to provide a more sophisticated long-term and analytically robust approach to appraisal and investment evaluation (HM Treasury, 2002-3).

This article goes on to suggest that a key element of the evaluation of the value for money of individual Private Finance Initiatives is the success with which risk is genuinely transferred from the public to the private sector and optimally shared between the two sectors.

## **6. The allocation of risk**

The main benefit of transferring risk from the public sector is that it should generate the incentives for the private sector to supply cost effective and higher quality services on time. Risk and reward go hand in hand. Private Finance Initiative suppliers usually only start to receive their service

payments when a flow of services actually starts, and continued payment depends on meeting performance criteria.

**Table 2. Weaknesses in the use of public sector comparators**

Private Finance Initiative deal	House of Commons Committee of Public Account's findings
Dartford and Gravesham Hospital	The NHS Trust did not detect significant errors in the public sector comparator. The Trust also did not quantify the full effects of changes in contract terms and of the sensitivity of the deal to changes in key assumptions, as the deal went forward. Had the Trust known that the savings were marginal when negotiating the deal, it might have made different decisions and achieved better value for money (Public Accounts Committee, 1999-2000b).
Airwave	A public sector comparator was not prepared until late in the procurement, and after a decision to use the Private Finance Initiative had already been made. It is therefore doubtful that the use of a comparator added to the decision-making process (Public Accounts Committee, 2001-2b).
Ministry of Defence Main Building	The public sector comparator gave a central estimate for the cost of a conventionally financed alternative to the Private Finance Initiative deal as £746.2 million, compared to an expected deal cost of £746.1 million. Such accuracy in long term project costings is spurious, and the small margin in favour of the Private Finance Initiative deal provided no assurance that the deal would deliver value for money (Public Accounts Committee, 2002-3a).
West Middlesex Hospital	The NHS Trust's advisers strove to make slight adjustments to the calculations, well within the range of error inherent in costing a 35-year project, so that the Private Finance Initiative cost appeared marginally cheaper than the public sector comparator (Public Accounts Committee, 2002-3b).

Private sector management skills are better harnessed and incentivised by having private finance at risk. The transfer of project financing risk generates incentives for the private sector to supply services on time and of a higher quality as they only start to receive payments when a flow of public services actually starts, and continued payment depends on meeting specified performance criteria.

The lenders to a Private Finance Initiative have a powerful incentive to identify, allocate and ensure the effective management of all the risks the private sector assumes in a project. One of the valuable features of private sector financing of Private Finance Initiative projects is the extensive due diligence work that private sector risk-takers carry out on projects. But the returns to financiers need to be commensurate with the risks that they are

actually taking and this in turn depends on the market being well informed and truly competitive. In some Private Finance Initiative projects the Committee of Public Accounts has found this not to be the case (Table 3).

The assessment of risk, and who is best able to manage it, needs to be carefully considered in the design of Private Finance Initiative projects. Value for money will be achieved where there is optimum transfer of risk such that individual risks are allocated to those best placed to manage them. If the public sector seek to transfer risks which the private sector cannot manage, value for money will reduce as the private sector seeks to charge a premium for accepting such risks.

**Table 3. Examples of inadequate competition**

PFI deal	Committee of Public Account's findings
Immigration and Nationality Directorate (Public Accounts Committee 1999-2000a)	Key figures, on which future increases in productivity would be measured and payments to the contractor calculated, had not been finally agreed until more than a year after the contract was signed. Such important issues need to be finalised before a contractor is selected and the benefits of competition fall away (Public Accounts Committee, 2003).
Dartford and Gravesham Hospital (Public Accounts Committee, 1999-2000b)	The NHS Trust selected two firms to submit final bids but one of the firms did not submit a bid. The Trust therefore ended up with only one final bidder on this major pathfinder project for the use of the PFI in the NHS. The bidder's final bid was 33 per cent higher in real terms than its indicative bid. The Trust did not undertake a detailed analysis of the reasons for the increase in the final bid, especially given the absence of other bids. Such action might have helped the Trust to secure a greater price reduction in the subsequent negotiations (Public Accounts Committee, 2003).
Newcastle Estate (Public Accounts Committee, 1999-2000c)	In this deal the Department of Social Security appointed a preferred bidder whilst important issues remained unresolved. Exclusive negotiations with the preferred bidder continued for 18 months (Public Accounts Committee, 2003).

The principle governing risk transfer is that the risk should be allocated to whoever from the public or private sector is able to manage it at least cost. An optimal sharing of risk between the private and public sector should recognise that there are certain risks that are best managed by the government and to seek to transfer these risks would either not be available or not offer value for money for the public sector. The government pays for inappropriately transferred risks through higher service charges. The optimum allocation of risk, rather than maximising risk transfer, should be the objective, and it is vital to ensure that value for money is not diminished.

This is illustrated by the case of the Private Finance Initiative contract to develop a benefits payment card system. In May 1996, the Department of Social Security and Post Office Counters Ltd jointly awarded a contract to Pathway, a subsidiary of the ICL computer services group, for delivery of the benefits payment card. The project was intended to replace by 1999 the existing paper-based methods of paying social security benefits with a magnetic strip payment card, and to automate the national network of post offices through which most benefits are paid across Great Britain and Northern Ireland. The project was vast in its scale and complexity, and estimated to cost some £1 billion in payments to Pathway. It was also one of the first information technology contracts awarded under the Private Finance Initiative. After delays and problems the government decided to cancel the benefits payment card with upwards of £1 billion in abortive costs, the write-down of assets and delayed reductions in benefit fraud.

The contractor chosen was selected because they were willing to take on a level of risk for preventing benefit fraud which the other two bidders for the contract would not accept, even though the contractor came third on eight out of eleven technical and management criteria. At the time, there was a mistaken view that Private Finance Initiative bidders should compete on the level of risk they were prepared to take on, rather than achieving an optimum allocation of risk (Public Accounts Committee, 2001-2a).

Private Finance Initiative schemes need to transfer to the private sector risks where the supplier can influence the outcome. The supplier is able to influence the likely performance of the building and its services by the quality of the design, construction and refurbishment work undertaken. The quality and frequency of maintenance also has an important bearing on on-going performance. Therefore, risks transferred should usually include design, build, financing and operating risks.

The ability to secure risk transfer on worthwhile terms means ensuring that the scope of a contract is sufficiently widely drawn. If the private sector has clear ownership, responsibility and control, it will take all the risks it can manage. If the public sector seeks to reserve to itself many of the responsibilities and controls that go hand in hand with ownership, and yet still seek to transfer the risk, the private sector will simply increase its price (and thus potentially damage value for money).

The National Audit Office recently surveyed a number of PFI contractors and the public sector bodies that had contracted them (NAO, 2001-2b). It showed that in some projects there is disagreement on whether risks have been allocated to the party best able to manage them. Only two-thirds of contractors shared the public sector bodies' view that risks had been allocated appropriately. Seventy-nine per cent of authorities thought

the risk allocation was totally satisfactory but only 53 per cent of contractors had this view. Contractors recognised that risk allocation was an important area where there were often problems. All the contractors who were dissatisfied with the risk allocation thought that risks had been inappropriately transferred to them rather than inappropriately retained by authorities.

For example, in the case of the first Private Finance Initiative contracts awarded to design, build, finance and operate roads, payments to operators were based primarily on traffic volumes which are, however, notoriously difficult to forecast. This was done to test the ability of the private sector to bear one of the risks involved in running tolled roads, but it created a new financial risk which bore both on the public sector and on the private sector and which neither party was able to manage effectively (NAO, 1997-8a). Bidders included a premium in their pricing for taking this risk which is likely to have reduced the value for money offered by these contracts. Private Finance Initiative contracts can deliver better value than traditional methods of procurement if risks are transferred to the parties best able to handle them. In this case risk transfer was confused with risk creation, which is simply likely to increase costs to the public sector.

Some contractors may be too willing to accept inappropriate risk. Some authorities may have been tempted to transfer as much risk as possible to the private sector. But if contractors accept inappropriate risk to win the competition, the subsequent realisation of those risks within a very competitively priced contract may lead to problems for the contractor and, therefore, for the authority. The due diligence carried out by contractors' banks may sometimes stop contractors taking on too much or inappropriate risk but this work is done on behalf of the bankers themselves and may not give full reassurance about project risks to other parties.

Some public sector authorities may transfer risk back to themselves. The essence of Private Finance Initiatives is that authorities provide contractors with an output specification of the services they require. Contractors then have the responsibility and risk for deciding how they will provide those services. If public sector bodies tell contractors how the services are to be provided, they are transferring the risk back to themselves. Contractors sometimes attempt to define the technical solution, or have expectations on how a service should be provided, which limits contractors' freedom to propose alternatives.

In the case of the road contracts mentioned above, following their signing, the operators put forward more than 3 000 variations and innovative ways of varying standards, which the Agency accepted. This suggests the core requirements in the original tender documents were too tightly drawn to

encourage novel ideas. However, the exploitation of private sector innovation is critical to the success of the Private Finance Initiative in delivering improved value for money.

Under Private Finance Initiative contracts not all risks can be or are suitable for transfer to the contractor. It is clearly important that authorities continually monitor risks to which they may be exposed and take steps to manage them. For example, under the terms of the Ministry of Defence's Fixed Telecommunications Service contract, it had become exposed to the possibility of having to pay the contractor (British Telecom) compensation of up to £12 million because the anticipated numbers of users paying for secure speech services was not sufficient to enable British Telecom to recover its initial investment in developing this service. Proactive management by the Ministry, working in conjunction with British Telecom, enabled a satisfactory resolution of this situation which involved changes to required volumes of users and the mechanisms for funding British Telecom's investment in the service. On this basis, British Telecom agreed not to press for the compensation to which it was entitled under the contract (Public Accounts Committee, 2003).

Where a Private Finance Initiative project concerns the delivery of an essential public service the public sector body may have no option, if the project fails, but to take back responsibility for delivering the service. In these circumstances it would be misleading for the contract to be drawn up on the basis that the risk of failing to deliver the service had been wholly transferred to the private sector supplier.

If contractors successfully manage the risks that have been allocated to them and deliver the services required they can expect to earn rewards commensurate with the level of risk that they have borne. But commercial discipline is undermined if contractors get the impression that risks will be taken back by the public sector if they materialise in any serious way. There are a number of examples where central government has done just this.

For example, in one case the Private Finance Initiative contractor was required to build and operate a new museum in Leeds for the Royal Armouries. However the government effectively bailed the company out to the tune of over £10 million when it ran into financial difficulties and faced imminent insolvency. There were no contingency plans in place, as it was considered that the risk of the project's failure lay with the contractor. However the business risks ultimately lay with the public sector as the government were unwilling to countenance the closure of the museum and therefore stepped in to rescue the project (NAO, 2000-1a).

The need to ensure that services to the public are maintained means that the risk of ultimate failure is one that sometimes cannot be transferred to the

private sector. In the case of an operational facility, such as a hospital, it would be normal in current contracts to have provisions enabling the public sector partner to take over the assets and their operation in the event of failure and/or to seek a new private sector partner. The contract might provide for the private sector partner to receive compensation for the transfer of assets to the public sector, thus addressing the problem of security for the project's financing.

Private Finance Initiative deals need to be structured so that, if the contractor gets into difficulties, there is a strong incentive for the financier to step in and either get the contractor back on track or, if that is not possible, replace the contractor with an alternative. Only where both these options fail should the public sector body normally step in. Even here this should not mean that the contractor is rescued or should not still pay a substantial financial price in the event of a rescue.

Good risk management requires a thorough appraisal of all the possible risks attached to a deal and the development of contingencies should the risks crystallise. This emphasises the importance of developing a successful partnership-based relationship between the public sector body and a contractor. Such a relationship is assisted by the right contractual framework, which includes allocating risks appropriately, establishing clearly defined quality of service and value for money mechanisms, and building in arrangements to deal with change. It is also essential that both parties to the deal understand their respective objectives, assess the prospects for a partnership, and make efforts to understand each other's business. As a deal progresses, the risks inherent in it will change and risk management arrangements therefore need to be reviewed regularly as deal risks change over time.

## **7. Accounting for the allocation of risk**

Generally accepted accounting practice draws a distinction between property and services, the former accounted as an asset and the latter as current expenditure. When a property has been built through conventional procurement methods, the public sector is almost always considered to bear the risks of ownership and the capital invested in that property is booked as an asset in the government's account and counts against the public sector borrowing requirement.

Generally accepted accounting practice also requires both private and public sector bodies to account for the economic substance of a transaction, rather than simply its legal form. This means that a party in a contractual relationship that reaps the benefits and bears the balance of risks of

ownership of a property has an asset of the property and must report this on the balance sheet. But this raises difficulties for Private Finance Initiative projects where, as we have seen, value for money depends on sophisticated allocation of risk between the private and public sectors.

The UK Accounting Standards Board has recognised these difficulties. It has issued guidance to help public sector bodies and their auditors determine ownership for balance-sheet purposes (UK Accounting Standards Board, 1994). It is based on an assessment of which party bears the majority of potential variations in returns relating to the Private Finance Initiative property. The UK Treasury has issued a Technical Note to supplement the Accounting Standards Board guidance (HM Treasury, 1997). The methodology recommended by this guidance for assessing which party has the majority of these risks identifies three sets of indicators that should be considered: qualitative, quantitative and other indicators.

The qualitative indicators are based on the concept that if the contractor defaults and, despite this, the debt financiers still get a full pay-out, if the equity input is minimal, or if the purchaser effectively determines the nature of the property, then these all indicate that the asset should be on the purchaser's (*i.e.* the public sector's) balance sheet.

The quantitative indicators are those risks – demand risk, design risk, residual value risk, etc. – that are capable of some sort of allocation and evaluation. And there will be some risks (the “other indicators”) that are so uncertain that it would be foolhardy to attempt a meaningful quantification, for example the risks of financial impacts arising from future changes in technology or public policy.

It is possible that a qualitative analysis of such indicators and risks for a particular project will give a clear idea of which party should include the asset on its balance sheet. The Treasury guidance states that “where demand risk is significant, it will normally give the clearest evidence of who should record an asset of the property”, and that “where it is significant, residual value risk will normally give clear evidence of who should record an asset of the property” (HM Treasury, 1997).

However it may not always be clear who should record an asset of the property without further detailed quantitative analysis of the risks to the property costs and revenues. The audited body and its advisers will typically start this process with some brainstorming by risk assessment workshops to consider all the potential risks and their likely quantum and who bears them. This process might not be carried out just for accounting purposes – it might be part of a wider process in assessing the likely benefits or otherwise of a Private Finance Initiative proposal generally.

The outcome of this exercise could be a risk register with a preliminary broad brush evaluation of the quantum of each identified risk for each of the parties. This should consider the probability of each of the identified risks materialising, the average financial impact and range and distribution of possible outcomes. This may then be refined by statistical methods to combine the range and impact of the risks through modelling techniques. The net present value of the quantified risks for each party would be compared and, subject to the qualitative and other indicators not providing a strongly contrary indication, the asset would be attributed to the party bearing the majority of the quantified risk.

There are a number of difficulties and judgements surrounding a quantitative risk analysis, and different interpretations of demand risk have arisen with public sector bodies and their advisers seeking to exploit these to ensure off-balance-sheet accounting. Small changes in “guestimates” and assumptions used in quantitative analyses can tip the results so as to provide an off-balance-sheet assessment when a more rounded and intuitive view based on all the relevant risk considerations would provide a different answer. This has led to a situation in the health and local authority sectors where Private Finance Initiative hospitals and schools are commonly not recorded on either the public sector’s or the private sector’s balance sheets. These difficulties tend to stem from a mechanical application of quantitative techniques combined with inaccurate assumptions and contentious argumentation to downplay the role of demand risk rather than a commonsense application of “generally acceptable accounting practice”.

An obvious effect of the Private Finance Initiative is to reduce the current public sector balance sheet and replace it with a stream of future liabilities. A private contractor picks up the bill for the construction of a new prison while the taxpayer guarantees it an income spread out over the lifetime of the asset so that today’s capital investment becomes tomorrow’s current spending. The signing of Private Finance Initiative contracts usually involves a commitment on the part of government to a future stream of payments for the services provided.

Future liabilities are recorded and published by the UK government but up until recently it was difficult to disaggregate those that were commitments as a result of the Private Finance Initiative. In response to a recommendation from the Treasury Committee in 1996 (HM Treasury, 1996-7), the Treasury now publishes forecasts of the committed expenditure for public services flowing from private sector investments under the Private Finance Initiative. Payments under Private Finance Initiative contract were estimated in April 2004 to rise to between £6.1 and £6.3 billion each year between 2006-7 and 2016-17 before declining to between around £2.5 billion each year between 2027-28 and 2029-30. In total over the

25-year period some £123 billion is committed (NAO, 2001-2b). These figures represent best estimates. Actual expenditure will in future years depend upon the payment mechanism details for each contract.

## 8. Conclusions

This article has argued that the success of the Private Finance Initiative cannot be judged solely of itself, but in relation to the record of conventional public sector procurement projects, which is not good. One of the benefits of its introduction has been to focus greater attention on the need to identify and manage better risks in the delivery of public sector procurement projects, not just those involving private finance. But the real success of Private Finance Initiative projects depends on the degree to which risk is genuinely transferred from the public to the private sector and optimally shared.

### Notes

- <sup>1</sup> These reports can be read at [www.nao.org.uk](http://www.nao.org.uk).

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