

The future of the Private Finance Initiative

Edited by Ann Rossiter

Report of the Social Market Foundation

Seminar series 2004

1. Cost and value for money

Overall, PFI initiatives have proved to deliver timely and cost-effective projects. Concerns regarding the costs of PFI have sometimes been overstated and have diverted attention away from an more considered view of problems with PFI programmes. Some of those, associated with early PFI project, have now been resolved, particularly since the Treasury has ruled some areas as being unsuitable for PFI (such as IT projects). Issues that remain often relate to procurement expertise and the management of markets. The Treasury's new guidance on Value for Money Assessment¹ has been broadly welcomed by those involved in the PFI procurement, in particular earlier decision-making at the strategic level, and the introduction of qualitative assessment to decision-making.

The structure of some PFI contracts, with penalties for failure but without rewards for success, is one case of problems with the PFI. A more qualitative assessment of performance with the option of contract negotiation in the operational phase is needed to address this problem.

2. The evidence for PFI

An evidence-based approach to decision-making about PFI schemes is vital. This is one of the major areas of concern for PFI's critics. It would be helpful for all parties to the debate around PFI to have more evidence on performance and costs, to justify, and improve, existing and future PFI projects. At present, some information is available on the construction phase of PFI schemes, but more evidence on on-going operation would be valuable. Publication of evidence should be encouraged.

3. The Public Sector comparator (PSC)

Some of the problems with the PFI have arisen because of the way in which the Public Sector Comparator (PSC)² has been used. It is designed to provide a way of comparing the value of a project delivering through the PFI with a project delivered through conventional procurement. However, the PSC has often been credited with a level of scientific accuracy which is not warranted, since it is based on a sometimes arbitrary set of assumptions. While there still a role for the PSC it should not be regarded as a precise estimate but instead should inform the qualitative assessment of projects. The Outline Business Case³ is the correct stage at which to use the PSC.

¹ 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.

² 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.

³ The Outline Business Case is prepared by the procuring authority to establish the need for the project, and consists

4. Improving procurement practice

Establishing a pattern of excellence in PFI procurement has been hampered by the failure to always spread best practice across the public sector, due to poor skills transfer and knowledge management. This has been a particular problem for local authorities. Central government has not always struck the right balance between giving local authorities responsibilities for their procurement, and supporting them when they lack the necessary skills.

5. Long term contract management

Managing ongoing PFI projects over a 20 or 30-year term emerged as the greatest unsolved problem. Greater attention needs to be paid to long-term management at the strategic and procurement stages. The successful delivery of services through a PFI scheme depends on a number of factors, including clarity at contract stage. However the creation of effective long-term relationships between the parties is also important. These may not be best addressed through the contract. Instead, good knowledge transfer, mutual understanding of needs, and trust between the parties need attention. However it should be said that failure to adapt in the long-term is a problem for public sector institutions, as well as those provided through PFI.

6. The need to manage the PFI market

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.⁴ 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 and requires government to take an active role in managing the market for PFI.

7. Competing in the PFI market

Bidding is a complex and costly process, and the prospect of investing in a PFI bid and losing it discourages all but the largest and best finances companies. The range of skills required – building, maintaining and services projects – means companies often have to form consortia to be able to meet all requirements. The returns for an individual company who must raise a large amount of equity to invest in a consortium are often slow to materialise and small, giving individual companies little incentive to maximise collective profits by ensuring they operate effectively.

8. Encouraging Competition

Those factors encouraging competition include:

- a stable market and visibly successful private sector firms. This should take precedence over encouraging competition in the short-term
- a shorter, sharper procurement process which lowers bidding costs
- well organised procurers with a clear conception of good value
- providing clarity about forthcoming procurement, for example by being transparent about where significant procurement programme will follow.

9. Market Innovations and the future of PFI

If PFI is to deliver projects in areas such as urban regeneration and social housing, more flexible models of PFI partnership, to allow smaller company involvement, need to be created. This may include allowing public sector partners to join private sector consortia to boost available capital.

⁴ Constructing the team, BEC and Sir Michael Latham, reproduced in *Seize the Initiative*, Dr Eamonn Butler and Allan Stewart MP, Adam Smith Institute, 1996.

Possible future methods of reducing bidding costs include:

- more LIFT-style partnerships⁵, with shorter procurement times increased standardisation of contracts
- fewer small PFI deals, where bidding costs are a high percentage of the total

10. Shortages of capable suppliers might be address by:

- partnerships like LIFT, needing less private sector equity
- direct government equity investment in PFI schemes
- stable markets attractive to bidders
- measures to make to UK construction industry in general appeal to international suppliers
- transparency about the pipeline of future work

12. The Failing PFI schemes

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

(The Social Market Foundation's main activity is to commission and publish original papers by independent academic and other experts on key subjects in the economic and social fields, with a view of stimulating public discussion on the performance of markets and the social framework within which they operate. The foundation is a registered charity and a company limited by guarantee. It is independent of any political party or group and is financed by the sale of publications and by voluntary donations from individuals, organisations and companies. The views expressed in publication are those of the authors and do not represent a corporate opinion of the Foundation.)

⁵ 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.