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Article

Lessons from the private finance initiative in the United Kingdom

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ABSTRACT

This paper examines the UK experience of PPP/PFI from a value for money perspective. It argues that a rounded view of overall performance has to consider the procurement process, the construction of the asset procured, and the operational performance that follows. Important changes have been made in the UK to the appraisal stage of the procurement process, raising the likelihood of PFI being chosen when it is most likely to deliver value for money. While PFI has evidently performed well in the construction phase, the UK experience suggests a number of prerequisites for achieving value for money in the operational phase. Good contract management is needed to ensure that the risk transfer paid for actually sticks. Provisions to manage changes to contracts in a way that preserves value for money are important. An ability to benchmark the cost and quality of services provided over the long term is also likely to enhance the value for money achieved.

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Lessons from the Private Finance Initiative in the United Kingdom

1. Introduction

The United Kingdom launched the Private Finance Initiative (PFI) in 1992 when it abolished rules that restricted the use of private capital to fund public assets. Under PFI the public sector contracts with private sector firms for the long term provision of a public service, on the basis of an output specification and a performance management regime. In other words, PFI transforms public sector bodies from being owners and operators of assets into purchasers of services from the private sector.

The private sector, in turn, takes on greater responsibilities and greater risk than under conventional procurement. The framework is intended to provide the private sector with a commercial incentive to build in whole-life costing, flexibility, and efficiency from the initial design and build stages right through to operation. 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 services.

By end-2004, 677 PFI contracts had been let in the UK, with a total capital value of some GBP 42.7 billion. Between 1998-99 and 2003-04, investment through PFI represented 10 to 13.5 percent of total public investment, and this percentage is not expected to change significantly over the next few years. Some 250 of these PFI contracts are in the health and education sectors and are almost entirely for the provision and management of assets rather than clinical or educational services. There are, however, no rules to prevent the use of PFI for frontline services. PFI prison contracts, for example, are for the operation of the prisons as well as construction and facilities management services. Some recent health deals include clinical services.

In February 2005, the UK National Audit Office (NAO) published its 50th report on PFI/PPPs. These 50 reports encompass deals, thematic studies – such as refinancing and managing the relationship in a PFI deal – and operational performance. The NAO is in the process of completing more studies of operational performance now that enough deals have been in operation for long enough to be assessed.

This paper aims to give a rounded view of the performance of PFI in the UK to help indicate under what circumstances and to what extent PFI is likely to deliver benefits. This is a complex issue with no easy answers – not least because of the shortage of information on operational performance. Moreover, lessons have been learned in the UK, and deals currently being negotiated are likely to be better value for money than earlier deals.

Assessing performance in the round requires analysis of the procurement process, the construction phase, and the operational performance achieved. Section 2 focuses on the procurement stage, outlining a number of issues that are relevant from the value for money perspective. The performance of PFI projects at the construction phase is reviewed in Section 3. Section 4 shifts the focus to the operation phase, identifying factors with a bearing on value for money.



Patricia Leahy

2. The PFI procurement process

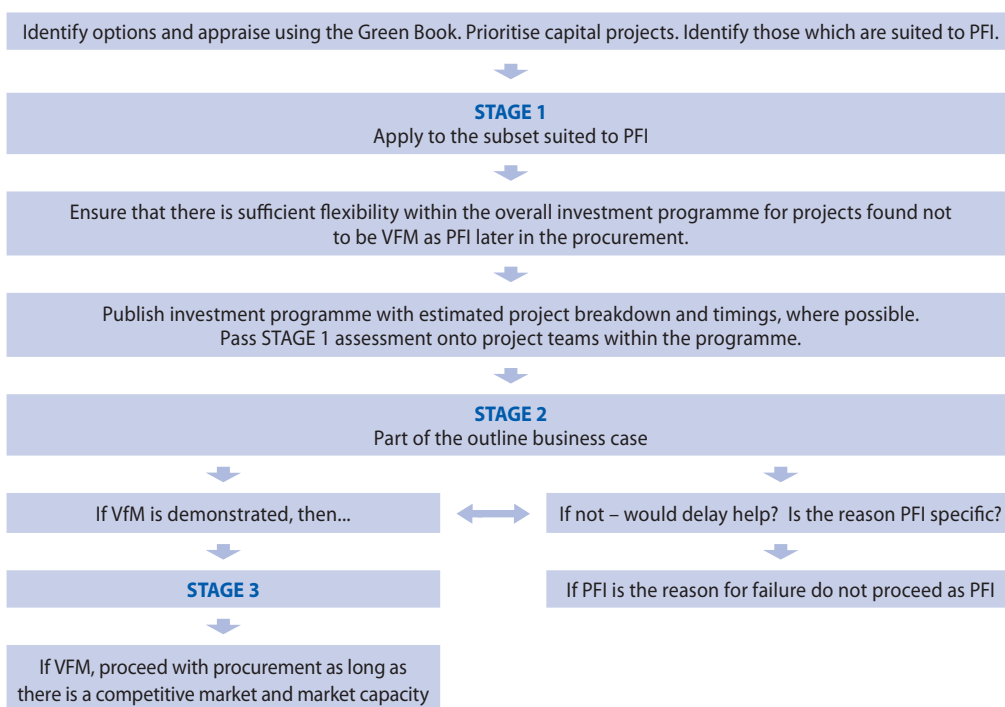
The NAO is unambiguous about the need for the decision to procure assets/services under PFI to be made on the basis of value for money, or VFM for short. This is also central government policy, and all PFI deals are assessed for value for money. To highlight the importance of the procurement process in achieving VFM, this section focuses on a range of issues at the procurement stage that have a bearing on the costs and benefits associated with the PFI option.

2.1 VFM appraisal framework

Comparisons with conventional procurement are most relevant at the outset when a strategic view on the method of procurement is important.

The framework for appraising value for money through PFI has been revised by the UK Treasury, as illustrated below. The new approach reflects the view, advocated by the NAO, that comparisons with conventional procurement are most relevant at the outset when a strategic view on the method of procurement is important. This new approach expects decision makers to determine at programme level for which sectors PFI would be an appropriate procurement route. When preparing the outline business case for a particular project, the project is appraised comprehensively, including an assessment as to whether the original choice of procurement route remains the most appropriate. If PFI is confirmed as the most appropriate procurement route, market capacity to deliver the project and the likely level of competition that can be achieved is assessed.

Figure 1. New UK PFI appraisal process



Source: H M Treasury

This new appraisal framework reduces the emphasis on the Public Sector Comparator (PSC), which can by its nature only deal with costs and suffers from a number of other shortcomings. Costs over 25-30 years are likely to be very uncertain, the results of the PSC analysis are prone to error, and the findings are easy to manipulate. In addition, important qualitative factors cannot be

taken into account in the PSC. They include the prospects for more certain delivery under the PFI and the advantages and disadvantages of being in a long term contract. Qualitative factors may indicate that the lowest priced bid is not the best, for example, if a higher priced deal offers a high quality solution that delivers the public sector's objectives better. There may also be doubts about a contractor being able to deliver the project for a low bid price. And the public sector is likely to retain responsibility for making a service available if a contractor falls into difficulties.

2.2 Risk allocation and management

The risks in a PFI deal 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. For each project, some risks are more relevant than others. In a road project, the key risks will be demand, design/asset construction, and maintenance, whereas in a prison project, the key risks relate to availability, performance, and operating cost 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. Notable examples in the UK include the London Underground Jubilee Line extension, which was delivered two years late and cost GBP 1.4 billion more than originally estimated, as well as the top 25 equipment projects in the Ministry of Defence, which experienced cost overruns of GBP 2.8 billion and average delays of three and a half years.

A key element of the evaluation of the value for money of individual PFI deals is the success with which risk is genuinely transferred from the public to the private sector and risk optimally shared between the two sectors. Where risk is transferred and the private sector is better able to manage it, value for money is likely to increase. Transferring risk from the public sector should incentivise the private sector to supply cost effective and higher quality services on time. Risk and reward go hand in hand in PFI deals - PFI suppliers usually only start to receive their service payments when a flow of services actually starts, and continued payment depends on meeting performance criteria.

The principle that governs risk transfer is that the risk should be allocated to whoever in 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 certain risks 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 vital to ensure value for money is not diminished.

Some contractors may be too willing to accept inappropriate risk. Sometimes the public sector may be 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 competitively priced contract may lead to problems for the contractor and, therefore, the public sector.

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. For example, the lenders may require

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additional standby or contingency funding to be added to the total finance committed during preferred bidder negotiations. This could be to cover risks that the public sector is in a position to retain. If the additional funding is agreed it will increase the unitary charge paid. The difficult issue for the public sector is how to determine the optimum balance for the particular deal.

Some public sector bodies may transfer risk back to themselves. The essence of the PFI is that contractors are given an output specification of the services required. 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.

Irrespective of the robustness of the agreed transfer of risks, there are, however, three broad categories of risk that will tend to remain with the public sector. They include the risk associated with the performance of statutory duties; the risk of political fallout when key public services are adversely affected if the PFI contractor fails to meet performance levels (real or perceived); and the residual risk from a failing contract. The public sector needs to keep these residual risks in mind throughout the procurement. It is sensible to plan mitigation measures and, if necessary, build appropriate provisions into the contract. Where more than one public sector organisation is involved, suitable risk-sharing provisions between the different bodies will need to be considered.

Standardised contracts have now been developed in the UK. A key benefit of this is the crystallisation, in contractual terms, of the distribution for many generic risks. The risks that remain to be allocated are project specific. During negotiations with the preferred bidder, the public sector tries to ensure that a common understanding about the distribution of these risks emerges. This understanding needs to be clearly documented and subsequently included in the contract.

Clarity about the distribution of risks is not sufficient by itself to achieve successful risk transfer. The procedures for managing risks are also important. These need to be unambiguous, particularly if the public sector is to control and mitigate the consequences of retained risks. To aid the public sector, the contract needs to be clear about the contractor's reporting requirements and contingency planning. It is good if the contract has been developed on the basis of openness. Such an approach should be beneficial in the event that a risk materialises and should facilitate a joint approach to problem solving. This would be assisted by a contractual payment regime that encourages the contractor to provide information in a way that helps monitoring his performance.

2.3 Competitive bidding

Competitive bidding is the best means of securing value for money in a PFI procurement.

Competitive bidding is the best means of securing value for money in a PFI procurement. There is some evidence of there being on average four bidders in PFI competitions in the UK although obviously this varies from deal to deal. The last stage of the new, three-part procedure for assessing whether PFI is the appropriate procurement route requires the public sector to assess formally both the quality of the market's competitive interest in a proposed project and the constraints that might restrict the market's capacity to deliver the project. This procedure should improve the way that market enthusiasm is tested for proposed schemes.

Experience in the UK suggests a few prerequisites to sustain bidder interest. Such prerequisites, discussed in detail below, include commitment to the project; efforts to keep bidding costs low; production of clear bidding requirements and a reasonable timetable for bidding; framing the contract around standard terms; and ensuring that at each stage of the procurement, the number of bidders remaining in the competition is not too large.

The private sector has often complained that high bidding costs and lengthy procurement processes lead to reduced interest. Often each shortlisted bidder has to prepare an outline design that meets the performance specification and to calculate a unitary charge priced from estimates of the whole-life costs (including construction, operational and financial costs). The selected preferred bidder will expend considerable sums as it negotiates the contract, prepares detailed designs, and engages experts to undertake due diligence for its financial backers. The volume of this work and the expertise required demand far greater expenditure from the bidder than it would have incurred in tendering for a similar sized conventionally funded project.

The high cost of bidding, when combined with other factors such as uncertainty about commitment to a project, may reduce competition for PFI projects. There is a benefit, therefore, from the public sector trying to keep bid costs low, for example, by assembling complete data packages, including terms of existing contracts, and, where appropriate, arranging for bidders to pool resources, for example to survey existing assets jointly. Using standard contract terms could also lead bidders to spend less on legal advice.

In planning each stage of the competition, consideration needs to be given to how many bidders are needed. Taking too many forward may result in some bidders withdrawing because they no longer view the expense of continuing to bid as worth the risk. Too few may lead to a premature reduction in competition. Giving bidders sufficient early information about the evaluation process at the end of each stage allows them not only to tailor their submissions, but also to estimate the cost of their commitment to the process.

In some cases in the UK, bidding costs have been reimbursed to attract and sustain private sector interest. This was agreed in the case of the London Underground PPPs when market interest started to fade and the bidding process proved very expensive. Naturally, the NAO expects any decision to reimburse costs to be taken in the light of a full assessment of the benefits compared to costs.

In the vast majority of procurements in the UK, competitive tension ceases after a preferred bidder is selected. After this there is a risk of 'deal creep', i.e., erosion of value for money, when negotiations continue. There are a number of steps that can be taken to control 'deal creep'. It is important to have a negotiating strategy built around a realistic timetable. Written confirmation can be sought that offered prices will remain firm for a specified time period, providing the specification remains unchanged. Where the preferred bidder has grounds to increase its prices, benchmarking can help give assurance that increases are reasonable.

2.4 Preserving value for money when the contract is changed

PFI contracts are long term – for up to 35 years. Changes to the originally specified services, therefore, are almost inevitable. NAO (2001) and (2003) show that in the UK, within two or three years of contract letting, 55 percent of PFI contracts had been changed and 22 percent of central government PFI building projects had commissioned additional building work.

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Clearly, provisions to manage future changes efficiently and economically need to be built into PFI contracts. This suggests that the public sector could usefully identify a range of reasonable triggers for change, including foreseeable legislative changes, and assess how these would impact on bidders' proposals. For changes that are considered reasonably probable in the short to medium-term, it would be possible to invite bidders to price the identified flexibility. This information could then be used to assess whether the inclusion of this flexibility would be value for money.

Value for money over the long term is likely to be enhanced if there are robust provisions that entitle the public sector to benchmark the cost and quality of the services provided over the life of the contract. The efficacy of these terms is likely to depend on the existence of appropriate dispute resolution terms.

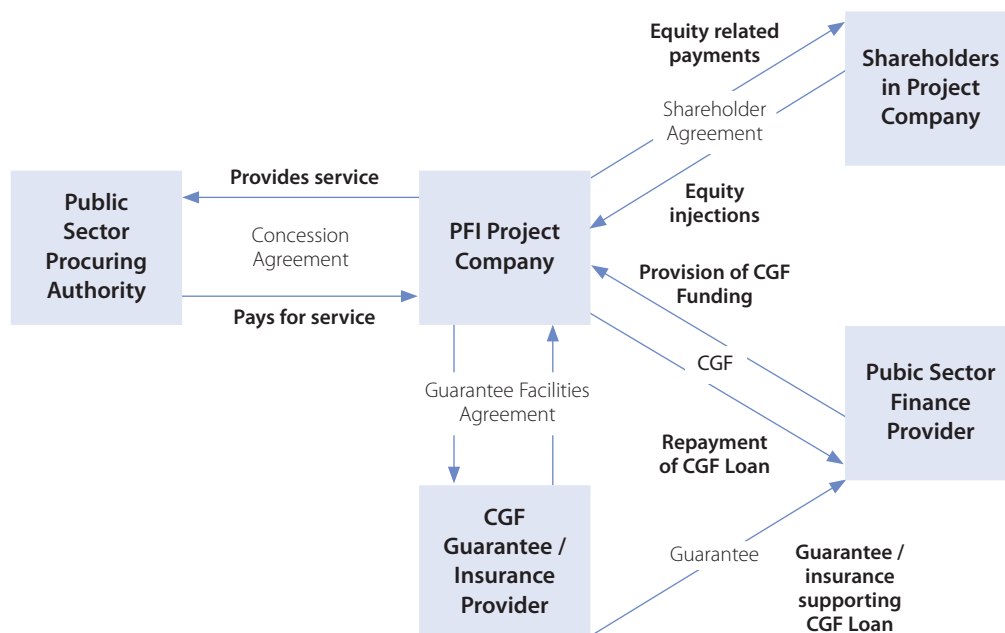
2.5 Cost of financing

The terms of the financing are of course crucial to the value for money of the deal. The financing of most PFI projects is obtained specifically for that project by a project company formed solely to fulfil the contractual obligations of the particular project – a special purpose vehicle (SPV). This SPV is formed by shareholders. In the UK, the initial investors, putting risk capital into the SPV, are most likely to be either equity funds or PFI contractors such as builders, or other service providers.

Credit guarantee financing is being piloted in the UK to reduce overall financing costs to the public sector.

A novel form of financing is currently being piloted in the UK by the Treasury to reduce overall financing costs to the public sector, while retaining the benefits of private sector companies taking risk on PFI deals. This is called credit guarantee finance (CGF), illustrated in Figure 2. Under the pilot schemes, a public loan is made available to the SPV provided that a private sector financial institution guarantees that the public loan will be repaid if the project company does not have the financial resources to do so. The guarantee is provided by a financial institution such as a bank or a monoline insurer. This has allowed the public sector to avoid paying the funding premium that lenders usually obtain when lending to PFI deals. The risk premium is still paid to the guarantor. At present, it is not considered sensible or desirable for this to be a standard approach to financing all PFI projects.

Figure 2. Illustrative CGF financing framework



Source: H M Treasury

There have been two pilot projects – the Leeds Teaching Hospital deal completed in October 2004 and the Portsmouth Hospital project, expected to be completed in summer 2005. The Leeds deal had a capital value of some GBP 200 million. Analysis by the UK Treasury suggests that this resulted in a significant saving on the cost of the debt as well as reductions in some of the usual fees and costs. This approach does increase the risk to the public sector slightly, and there are some additional administrative costs. The Treasury will be seeking to demonstrate that it leads to overall benefits at the end of the pilot stage.

2.6 Sharing of refinancing gains

The refinancing of PFI projects is most likely to occur in circumstances where the risks inherent in the deal to the providers of finance fall relative to the risks at the time when the deal was initially financed. The maturing of the PFI market has brought more providers of finance and more competition in the provision of finance such that better financing terms can now be obtained than when the early deals were entered into. Refinancing can also be beneficial for projects where the construction phase has been successfully completed. As there are risks attached to completing the construction of a building successfully, it may be possible to refinance the project on more favourable terms once construction has been completed. Finally, the providers of finance may be prepared to provide additional finance, or to relax certain terms of the finance, to allow the SPV to improve its financial situation by continuing to operate in a distress situation.

A refinancing can be effected in a number of ways. The period over which the finance has to be repaid can be extended; however, in this case, the public sector needs to be clear if asked to extend the PFI contract period that there is a value-for-money argument for doing so. In addition, the finance can be provided on better interest terms, or the amount of debt finance can be increased. Furthermore, the initial equity finance or subordinated debt can be repaid out of additional cheaper bank or bond finance. Or other terms can be improved, such as lowering cover ratio requirements. Furthermore, although not falling within the Treasury definition of a refinancing, the initial equity investors may sell their investment to another investor.

Following agreement with the private sector, UK Treasury guidance now requires the sharing of refinancing gains as follows. First, on PFI deals entered into before autumn 2002, where there is no provision for the sharing of refinancing gains in the contract, the public sector will receive 30 percent of most refinancing gains under a Voluntary Code accepted by the private sector. Second, on all new deals after autumn 2002, the public sector will receive 50 percent of any refinancing gains.

UK Treasury guidance now requires the sharing of refinancing gains.

A 2005 NAO report covering a refinancing indicates what this can mean in terms of a real deal (NAO, 2005a). This report on the Darent Valley hospital, which in 1997 had been the first hospital to be procured under the PFI, explained that the Hospital Trust had received a GBP 12 million gain (in present value terms) through sharing in a total GBP 33 million refinancing gain generated by the contractor. This was achieved by increasing the level of borrowing and obtaining better financing terms as the PFI market had matured and the new hospital had been delivered.

Although benefiting from the refinancing, the Trust also faced new risks. It agreed to extend the minimum contract period by seven years and to accept the possibility of increased liabilities in the event of the contract being terminated early. The Trust concluded that these arrangements were value for money considering that the new minimum contract period of 35 years was in line with PFI hospital contracts at the time and that early termination of the contract was unlikely. But the NAO cautioned that, in future, authorities should undertake further analysis before agreeing to a refinancing that involved increased levels of private sector debt and higher public sector termination liabilities.

3. The construction phase

Turning now to the construction phase and focussing on the question of how well PFI has performed, there is a great deal of evidence that construction of an asset under PFI is usually to time and budget – unlike experience under conventional procurement. But under PFI the budget will, of course, be bigger to start with as risks are addressed and provided for explicitly upfront.

PFI projects continue to outperform conventionally procured construction projects in terms of delivering on time and within budget.

In 2003 the NAO reviewed completed PFI construction contracts across central government in England (NAO, 2003). The report found that PFI projects were delivering price certainty to departments, with 29 out of the 37 projects (78 percent) surveyed reporting no construction-related price increase after contract award. Where there had been a price increase, it had been due to changes led not by the contractor but by the department or other parties. The report also found that 28 out of the 37 PFI projects surveyed were delivered on time or earlier than specified in the contract. Where PFI buildings were delivered late, departments were able to defer payments, make payment deductions or seek damages.

A 2005 NAO report found considerable improvements in the delivery of all central government projects compared to the NAO's last investigation in 2001, which had only covered conventionally procured projects (NAO, 2005b). Nevertheless, the evidence shown in Table 1 suggests that PFI projects continue to outperform conventionally procured construction projects in terms of delivering on time and within budget.

Table 1. Delivery of construction on time and budget (in % of projects)

	PFI (2003)	Conventional (2001)	All central government (2005)
Exceeds price agreed in contract	22	73	45
Late to public sector	24	70	37
Over 2 months late	8	n/a	n/a

Source: NAO (2005b)

These findings are supported by research carried out by the UK Treasury in 2004 which reported 88 percent of completed PFI projects coming in on time or early, and with no cost overruns on construction borne by the public. A report commissioned by the Treasury also found that outturn costs of conventional procurement construction projects were 2 to 24 percent higher than the estimate in the business case.

4. Operational performance

While there has, so far, been limited experience of operational performance of PFI contracts, the NAO has attempted to identify and report initial trends. A key finding is that PFI projects are generally delivering the required services, but there has been variation in operational experience. For example, in our investigation into the operational performance of PFI prisons, we found that the best PFI prisons were outperforming most public prisons in our study group, but the lowest performing PFI prison was amongst the worst in the prison estate.

The early stages of a PFI project may especially involve risks while the service is being introduced and while the authority contractor relationship is being established. If serious problems arise, and the parties cannot, or do not want to, terminate the contract, some form of renegotiation may be necessary that may adversely affect operational performance. This has been a particular feature of complex IT projects – which are not normally now undertaken under the new appraisal guidelines. But this problem has also affected other types of projects. For example, the Royal Armouries museum contract was renegotiated when the contractor experienced financial difficulties because of lower-than expected revenue from visitors.

Finally, it is fair to observe that the public sector is at an early stage in understanding the skills that are needed to develop successful contractual relationships, how to deal with changes, and how to maintain value for money in the long term.

But going beyond what has happened, we need to ask which factors affect the management of the operational phase of PFI projects. The picture that transpires here can be summarised under the following headings:

Contract management. The public sector, from the start, needs to be an intelligent client. This necessitates developing and implementing a coherent strategy and engaging a suitable contract manager. In the UK, there is recognition that career structures in the public sector must place greater value on contract managers' skill sets than has hitherto been the case.

The public sector needs to be an intelligent client.

In some cases, there has been too little knowledge transfer between the procurement team and the contract management team. While the skill sets are different, the contract management team needs a direct understanding of how the contract was negotiated and what the public sector's rights and obligations are. Rather than completely dissolving the procurement team immediately after awarding the contract, it is sensible, at least in the short term, for some key members to advise the contract manager about the structure of the contract. The contract manager and other key contract management team members will be more effective if appointed sufficiently in advance of the contract award so that they have the opportunity to become familiar with the agreement from its start. This approach would also allow the contract manager to advise the procurement team about the practicalities of proposed management structures included in the contract and to help decide the level of resources required to manage the contract adequately.

While the efficient and effective management of a contract requires a properly resourced contract team, headed by a well-informed and motivated contract manager, the relationship the team has with the contractor is just as important. Key personnel in both the contractor's and the public sector's teams need to work effectively together if a successful relationship is to be built and sustained. The better the relationship, the more likely it is that the parties will work together to achieve a mutually beneficial outcome.

Contract evaluation. If authorities do not have procedures in place to evaluate their PFI projects comprehensively they may experience difficulties in determining the extent to which they are meeting expectations, for example whether they are delivering services of the required quality or realising any non-financial benefits which justified the projects. Central evaluation of operational performance is also useful.

The NAO has found that authorities do not always comply with best practice in terms of testing user satisfaction following the commencement of service delivery. The NAO has recommended that user surveys should be part of the post-contract evaluation process. Where there are a number of different stakeholders intended to benefit from the services, the public sector could usefully collect qualitative data from them all, for example through focus groups and questionnaires.

The actual return that the contractor earns compared to the risks it bears is also important. In the UK, comprehensive information on this is not available centrally.

Performance monitoring and sanctioning. The NAO has emphasised the need for the public sector to have in place, from the start of the contract, appropriate means of measuring performance that is directly linked to the payment regime. In contracts where services had been piloted, often IT projects, authorities have come under pressure to accept delivery of services and certify satisfaction with the pilot projects without the contractors demonstrating full contractual compliance. Although this should be avoided, there may be circumstances when it will be in the public sector's interest to accept provisionally a pilot, albeit with some aspects of service provision yet to be proved. In such circumstances, the public sector must ensure that it retains the right to terminate the contract, if, after a specified date, the contractor fails to deliver fully compliant services.

Before the project is operational, the contract management team needs to be properly resourced to monitor performance and to understand the contractual pricing mechanism. The design of the performance and payment deduction provisions will have to aim at encouraging the contractor to remedy poor performance quickly and so the provisions should generally be enforced. If they are not, there is a risk that the overall balance of incentives and penalties will be disturbed to the detriment of the overall deal. In the UK deals we have monitored, there has generally been a low level of payment deductions. This may in part be a reflection of good service delivery. But we have noted that payment mechanisms often do not result in high levels of deductions. There is inevitably some subjectivity in measuring performance, but as far as possible this should be minimised to avoid disputes and to help achieve payment deductions that are commensurate with the impact of poor performance.

While the performance and payment regimes apply to the PFI contractor, the public sector also needs to maintain a close interest in the performance of key subcontractors. This is particularly important if problems within the supply chain might delay or reduce the quality of the services. It is reasonable to expect public sector monitoring to be capable of identifying emerging problems early, including the potential insolvency of a key subcontractor.

Critical to the long-term success of the project will be the public sector's ability to master the management of change during the operational phase.

Contractual changes. Critical to the long-term success of the project will be the public sector's ability to master the management of change during the operational phase. When a change to services is required, a successful outcome will have to rest on proper and early preparation. Developing a business case to support major changes is sensible. Apart from justifying the change, this could set out a robust negotiating strategy for the public sector that includes a realistic fallback position. Before ordering a change, the public sector client will want to be satisfied that the proposed terms provide value for money. Knowledge of market prices for the delivered services and comprehension of what inputs are required to implement the change would inform decisions on whether to challenge the contractor's price structure. As the change process involves negotiation, the public sector client will need skilled negotiators.

The public sector would also benefit from regular reviews of whether the performance measurement regime in its PFI contract continues to meet its business goals. Where there was a mismatch, the public sector would need to determine what changes were required to the contract.

Refinancing issues. As discussed in Section 2.6, refinancing is an extremely complex issue and in 2002, the Treasury and the Office of Government Commerce introduced new guidance. The public sector needs to be very alert and well advised in dealing with refinancing proposals. It must also deal with the perception that value for money has been eroded by the increased rate of return that the contractor may earn following the refinancing even when the gain is shared. This highlights the need for a good understanding of refinancing issues and for contractors to be required to notify the public sector client of all refinancings. When a refinancing is proposed, the public sector is likely to need specialist help – available in the UK from Partnerships UK as well as from other advisers.

Contingency planning. The public sector needs to understand how interruptions to service delivery, or unsatisfactory service delivery, would impact on the execution of its statutory duties and key business activities. To mitigate such potential risks, contingency plans are needed; in fact, they should be available from the start of the contract and kept up to date.

Throughout the contract period, the contract management team should continue to monitor risks that could adversely affect the delivery of services. This information should provide early indications of potential service interruptions or deficiencies and so provide an opportunity to refine and implement contingency plans in a timely manner.

There may be situations where the contractor loses money on the project, and the public sector client, having established a valuable working relationship with the contractor, wants to avoid the contract collapsing. There would be a danger in increasing payments to the contractor because to do so would potentially signal to the PFI industry that the public sector is prepared to rescue contractors that get into difficulties. A better strategy is for the public sector to review what other actions it and the contractor can take to improve the latter's position. A good general principle is that any reallocation of risk should aim to preserve the original deal benefits.

Problems have emerged in a number of UK deals where the contractor generated some, or all, of its revenue directly from the paying public. We have found that the most optimistic bidder usually won the competition. In some cases, the winning bidder's forecasts proved to be over-optimistic and it subsequently got into difficulties. What is needed to temper bidders' optimism is effective due diligence. This process is a positive feature of most PFI deals but will be most effective where the contractor's equity is substantial and genuinely at risk, and a reasonable proportion of the debt is exposed to project risks.

Contract termination threat. Poor performance by a contractor may put the contract at risk of termination. In the UK, there have been very few examples of contract termination. This is partly because action has been taken in some cases to renegotiate projects that have experienced difficulties. Moreover, effecting a termination is not an easy option – there could be grounds for dispute and the public sector would have to pay termination liabilities and find a new contractor. Nevertheless, there have been some examples – a contract for the National Physical Laboratory was terminated following negotiation and Jarvis, one of the biggest PFI contractors, was replaced as the main contractor on various school projects.

In the UK, there have been very few examples of contract termination.

If termination is to act as a viable remedy, the public sector client needs to be aware of when it would be entitled to terminate the contract and must be prepared to use the powers. It could be sensible, as part of its contract management procedures, for the public sector to draw up and maintain contingency plans for contractor default, even when this is perceived unlikely. In producing a plan, the legal position on terminating the contract should be clearly spelt out, including rights to take possession of assets and compensating the contractor. It needs to be recognised that when a public sector client is entitled to terminate a contract, it could be hindered from exercising that right because it could not afford the short-term costs of such an action unless overseeing bodies gave it assistance.

5. Conclusions

This paper has considered the PFI experience in the UK from a value-for-money perspective. To offer a rounded assessment, the procurement, construction, and operational phases have been considered separately.

As regards the procurement phase, a number of factors affecting value for money were analysed. To start with, changes made to the VFM appraisal framework, including reduced emphasis on the Public Sector Comparator, were argued to have increased the likelihood that PFI procurement will be chosen when it is the option most likely to deliver value for money. In terms of risk allocation and management, the UK experience underlines the need to avoid excessive risk transfer for its own sake, as this will be expensive and is likely to lead to problems for the public sector down the road. Furthermore, competitive bidding is key to achieving value for money, and the UK experience suggests a number of prerequisites for it. Finally, financing arrangements can also affect the creation of value for money, and some lessons about the choice of financing structures and the sharing of refinancing gains could be drawn from the UK's PFI experience.

There is a need for effective monitoring and sanctioning of the performance of the private sector partner.

While it was documented that PFI has scored well in the construction phase compared to traditional public procurement, experience of operational performance remains limited to date. Nevertheless, work carried out by the NAO allows the identification of a number of factors that affect the performance of PFI projects. Such factors relate, most notably, to the management of the contract, with any changes requiring in-depth analysis of the costs and benefits. In addition, there is a need for effective monitoring and sanctioning of the performance of the private sector partner. In particular, contract termination has to constitute a credible threat.

Finally, it has to be acknowledged that the long-term nature of PFI projects and their dynamic impact on the economy raises a host of other issues that are equally important when assessing the successes and failures of PFI. Such issues include corporate governance in PFI structures; the accounting treatment of PFI projects; and the regenerative impact that PFI may have at the local level. A detailed discussion of these issues goes, however, beyond the scope of this paper.

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