

EDITORIAL: PPP/PFI – SOLUTION OR PROBLEM?

David Parker

Historical background

An essential requirement for economic growth is the provision of efficient, reliable and affordable infrastructure services, such as roads, schools, hospitals, housing, ports and public transport. The question is whether they are better privately or publicly supplied. The history of state provision threw up so many examples of service failure and huge cost overruns that, in the 1980s and 1990s, in Britain and elsewhere, governments turned more to using the private sector. With governments unwilling to give up control of the infrastructure services, the services were not to be privatised in the normal way. They were to be publicly funded and controlled but privately supplied. The foundation stone of public–private partnerships (PPP) and their manifestation in Britain in the form of the private finance initiative (PFI) was laid. PPP is the label used to cover a range of different types of partnerships with the private sector, of which PFI is a type formulated in the UK (see HM Treasury, 2000). For most purposes the two terms can be used interchangeably.

In one sense the public sector procuring services from the private sector is not new. No government department produces its own stationery or computers, and construction projects have normally been undertaken by private sector firms. What was new in the 1990s was the greater reliance on the private sector for activities previously undertaken in-house, such as the operation of IT systems and the management of building schemes. Under PPP/PFI the public sector enters into long-term contractual arrangements, which involve private sector companies designing, building, financing and in many cases operating infrastructure assets. This has continued into the present decade (see HM Treasury, 2003). In 2003/04 PPP/PFI schemes accounted for 39% of capital spending by UK government departments, although this fell to 11% in 2005/06. By January 2008 there were over 500 operational PPP/PFI projects with a total capital value of around £44 billion and a further number in the pipeline. A number of other countries have also been active in

promoting PPP schemes, as illustrated in this issue of *Economic Affairs* by Professor Erik-Hans Klijn's study of PPPs in the Netherlands and the paper by Professors Graeme Hodge and Carsten Greve.¹

In deciding on whether to use the private sector or provide in-house the decision is based on 'a rigorous assessment of value for money with no bias in favour of any particular procurement route', according to HM Treasury (2003). In the UK the largest sector by value for PPP/PFI has been transport due to large schemes such as the Second Severn Crossing, the Docklands Light Railway extension, the Heathrow–London rail link, the Channel Tunnel Link and the M6 relief road around Birmingham, followed by health and defence. Currently the government is using the private sector to help turn around the decaying stock of schools. Value for money (VfM) is the basis on which the public sector is expected to decide whether to produce internally or procure externally. Central to the interpretation of VfM is the concept of shifting risk. In essence PPP/PFI is intended to shift risk from the public sector, and hence taxpayers, on to the private sector, and hence company shareholders. In return for taking risk, the private sector is rewarded by the opportunity to profit from its superior project management skills.

The origins of what became the PFI programme of the 1990s went back to the early 1980s, when there was an expectation that the introduction of private capital into the financing of public sector projects and service delivery would help reduce public borrowing. It was also felt that the private sector would be able to input management skills missing within government. At this time the treatment of private capital for public projects was reviewed by the Treasury. This led to certain 'rules' or criteria that departments were expected to take account of when deciding whether to use private capital to fund public projects. The rules were formulated by Sir William Ryrie, a senior Treasury official, and were released in 1981 by Leon Brittan, then Chief Secretary of the Treasury. Brittan summed up the central theme of the rules that

'funds for investment should be taken under conditions of fair competition with the private sector; that is, that the latter should not obtain a normal equity profit without accepting a normal equity risk'.² Benefits from using the private sector would have to be set against the differential cost of financing in the private sector compared with the public sector. Because of the low risk of default, government can generally borrow at a lower cost than private sector firms.³ In effect, the 'Ryrie rules' required that the net yield of a PPP project should be greater than if it were publicly financed by at least enough to cover the increased cost of raising risk capital from the financial market. In other words, the gains would have to more than offset the additional cost of raising finance from the private sector, compared with gilts sales, if the proposal was to be approved. As one commentator, Simon Jenkins, concluded: 'They [the Ryrie rules] became a standing joke. Ryrie drew them so tightly as to make them inoperable. Not a pound of private/public investment was allowed through under the "Ryrie rules"'.⁴ This may be an extreme judgment, but what is certainly clear is that the rules limited the uptake of PPPs in the 1980s and thereafter.⁵

During the 1980s there were a number of unsuccessful attempts to navigate around the Ryrie rules and this left the private sector doubtful as to whether the government was committed to the use of private finance for public sector projects. For example, the first major infrastructure project to be seriously considered for private financing was a proposed new road in the Midlands with revenue to the contractor to be based on a 'phantom toll' over a 25-year concession period. The 'phantom toll' would be set on the basis of the number of vehicles using the new road, involving a measurement of traffic volume by the Department of Transport. But the Treasury rejected the proposal on economic grounds. The main stumbling block was the Ryrie rules.

However, in March 1986 the proposal for a new privately-financed Dartford River Crossing was successful. The project involved building a new bridge across the Thames at Dartford and the purchase of two existing tunnels there, at a price equal to the outstanding debt relating to their original construction. In September 1986, following a tender and negotiations, a consortium led by Trafalgar House won the contract. The consortium would be responsible for building and operating the new bridge and operating and maintaining the two tunnels during the concession period, of up to 20 years. Tolls would be levied by the consortium to finance the scheme, which was expected to cost in the region of £170 million. At the end of the concession period or when all of the debt from the new bridge and tunnels had been repaid, whichever was the earlier, the bridge and tunnels would be transferred to government ownership free of charge. Should the venture fail at any time, the bridge and tunnels would revert immediately to government ownership.

The Dartford River Crossing concession was important in the evolution of what became known as PFI because it was the first major infrastructure development in Britain to be financed by the private sector since 1945. A new company, the Dartford River Crossing Company, was formed, with nominal equity capital of £1,000. The main financing for the project came from 20-year subordinated loan stock, 16-year loan stock and £85 million as a term loan from banks. The banks also

committed to further loans of up to £20 million to cover any cost overruns. The contractor that built the bridge took the risk that it might cost much more to build than expected, and operating and financial risks were effectively borne by the debt holders. As risk had been transferred to the private sector, the scheme was deemed to fulfil the Ryrie rules.⁶ The Dartford scheme demonstrated that with careful navigation, the Ryrie rules were not the formidable barrier to private financing of public infrastructure that many had assumed.

Following agreement on this concession, the government encouraged the private sector to take the initiative and bring forward other infrastructure schemes for consideration. As a result, private finance was attracted into a number of major infrastructure projects, including the Channel Tunnel and the other transport projects mentioned earlier.

Twenty-first-century PPPs

PPP/PFI schemes often have lives of 20 to 30 years or more. Typically annual price increases are built in to reflect inflation with other price changes negotiated periodically during the life of the contract, to reflect changing circumstances and specifications and costs not reflected in the national inflation rate. However, it is inevitable, given the long life of the projects, that changes will be needed not just to prices but to the other terms of provision of services and assets. In turn this puts a considerable emphasis on the development of appropriate procurement skills within the public sector. An estimated £180 million was paid by public authorities to PFI contractors to undertake contract changes in 2006. Partnerships UK (PUK) was set up in 2000 to replace a Treasury Taskforce established by the Labour government in 1997 with the objective of reinvigorating the PFI programme. Its aim is to improve PPP/PFI procurement processes within government.⁷

A National Audit Office report in 2001 revealed that some 73% of traditionally procured central government construction projects in the UK had come in over budget. Therefore, there is considerable scope to improve the procurement of public infrastructure through PPP/PFI. Whereas under traditional procurement, typically the public sector designs the project and the private sector builds to this design using either cost-plus contracts (with their well-known moral hazard problems) or fixed-price contracts (which the private sector dislikes, understandably given unpredictable cost inflation). Under PPP/PFI typically the public sector sets the goals of the project (for example, in terms of the size and general specification of the hospital), but allows the private sector to come forward with differing ways of achieving the specification. Also, very often the private sector becomes responsible for managing and running the facility for a specified number of years and therefore the 'whole-life costs' of the project are internalised. For example, if the private contractor skimps on the initial build, the higher costs of maintenance and repair will fall on its budget later.

The standard approach to arranging PPP/PFI contracts is for the public body to advertise for bids. The bidders are then shortlisted based on price and ability to deliver. A 'preferred bidder' is then chosen and generally some months pass during which this bidder seeks the remaining information it needs to finalise the bid. The final contract price can vary and often

does, especially for more complex projects, from the original bid price that has been submitted. The public body has the opportunity to reject the final bid and go back out to contract, although if it does so many months will have been lost. This introduces an element of moral hazard into the tendering process, in the sense that the preferred bidder can factor into its calculations the likelihood of the public body challenging the new price and reopening the bidding. Given that the delay caused by rebidding adds to costs within government and may mean that the project has to be withdrawn if in the meantime public sector budgets have been tightened, this tends to mean that departments are reluctant to reopen the bidding.

By using the private sector, taxpayers benefit from the project management skills of private sector firms, and civil servants can concentrate on doing what they do best: running their departments. However, there are a number of possible problems associated with the use of PPP/PFIs. The first is that they can be adopted, as in the case of the present Labour government, as a substitute for full privatisation. Whether building and running schools and hospitals through PPP/PFI is a long-term solution to failing public sector education and health services is debatable. As the study in this issue by Dr Mark Hellowell and Professor Allyson Pollock graphically illustrates, PPP/PFI is storing up huge costs for future generations and meanwhile distorting resource allocation within the NHS.⁸ It is far from clear that the result is better healthcare (although the result may cheer up HM Treasury by pushing costs forward into future years or taking them 'off-balance sheet'⁹).

The second problem is that the true long-term costs of PPP/PFI are highly uncertain. In a number of cases the expense may exceed the costs that would have been incurred under more traditional government procurement methods. The costs are uncertain, in part because of inadequate project accounting and because of the risk of contract defaults. If a private sector company begins to lose money on the contract and the government refuses to renegotiate the price then it is possible that the private sector will withdraw, leaving the taxpayer to pick up the pieces. As consortia of firms tend to bid for PPP/PFI contracts, bringing together the necessary skills, the PPP/PFI contract is normally with a 'special-purpose vehicle' or company set up to build and manage the project. It is this company that is put into receivership. Both the papers in this issue by Professor Martin Ricketts and Dr Robert Jupe detail the collapse of Metronet, a contractor operating part of the London Underground, after severe cost overruns. Nor is this an isolated incident: in 2004 the construction company Jarvis was brought to its knees by a PFI contract signed four years earlier to refurbish eight schools in the North-West. Jarvis made the mistake of quoting too low for what was a fixed-price contract.

In any contracting there are problems of adverse selection and moral hazard arising from information asymmetries. Transaction costs apply in any form of contracting between principals and agents which involve 'incomplete contracts', as discussed by Professor Ricketts in this issue – and long-term PPP/PFI contracts are inherently incomplete. The transaction costs arise from the costs of negotiating, monitoring and enforcing the contracts. Ideally, if the contract is a true 'partnership' then the transaction costs should be reduced because the incentive for 'opportunistic behaviour' is curtailed.

The public and private sectors work harmoniously together on a project, adapting and compromising as they go on. As Professor Klijn emphasises in his paper, in the Netherlands the true partnership form of PPP has made headway. But too often partnerships quickly fall apart. In the UK a number of PPP/PFI schemes have collapsed after negotiations have been more akin to a battlefield rather than a partnership.¹⁰

In so far as there is mutual distrust at the outset, the contract tends to be quite tightly specified, leaving less scope for adaptation later. On the one hand, the government justifies the case for detailed contract specification to protect the Treasury from later demands for more financing and to protect against shoddy work. The private sector may also favour tight contracts if it is suspicious of future behaviour within government. On the other hand, this tells against adopting true 'partnership' agreements; this notwithstanding occasional Treasury guidance aimed at improving the arrangements.¹¹ The third difficulty with PPP/PFI, therefore, lies in a legacy of distrust that exists between the public and private sectors in the UK. This is not assisted by the tendency of politicians to change 'the rules'; for example, the decision of the Labour government, under pressure from trades unions, that contractors should operate specified employment policies. This sort of problem is not limited to the UK. The World Bank has discovered a high incidence of contract renegotiation for PPP-type contracts with the private sector in low- and middle-income economies. The transportation and water sectors are especially prone to this, with rates of 55% and 75% respectively in Latin America and the Caribbean. Moreover, much of the renegotiating occurs quite quickly: the time between the start of operations and renegotiation averaged a mere two years.¹² A number of low- and middle-income economies suffer from a degree of political turbulence that tells against even short-term arrangements with the private sector.

Fourthly, in deciding on whether to procure through PPP/PFI, public sector bodies in the UK are expected to test the cost against other forms of delivery, such as retaining the activity in the public sector. This should occur at the initial stage of deciding on the bids and periodically during the life of the PPP/PFI where the contract involves the longer-term provision of services. These tests usually take place at intervals of five to seven years. Value testing may involve comparing the incumbent's provision with comparable services (benchmarking) or may even involve inviting other suppliers to compete for the work in open competition (market testing). However, as the paper by Dr Hellowell and Professor Pollock identifies, in the health sector, at least, the record of VfM testing is far from satisfactory. In October 2006, HM Treasury issued new guidance to departments on value testing in an effort to improve practices.¹³

The March 2008 Budget confirmed the UK government's continuing support for PPP/PFI to deliver a range of public services.¹⁴ There is no outward suggestion of any lessening of support for this method of procurement in the Cabinet or HM Treasury, although there is some concern, privately expressed, about both VfM and the long-term cost to taxpayers.¹⁵ Elsewhere in government, however, worries are more openly voiced about the quality and cost of some PPP/PFI schemes, in terms of delivering good public services and value. Such views

surface in reports from the National Audit Office (NAO). A recent NAO report revealed that of the 600 PFI projects let, around 500 were now at the operational phase. On VfM testing, after investigating admittedly a small number of the projects, the NAO disclosed: 'in some of these initial cases the value testing had demonstrated value for money was being achieved, but in other cases the outcome was uncertain'.¹⁶ Two difficulties identified were a lack of adequate benchmark data and the time taken to undertake value testing, typically nine to 25 months. The recommendation was that departments should ensure that their PFI project teams were familiar with and adopted the Treasury guidance on benchmarking and market testing. However, past experience of civil servants receiving new guidelines suggests that this is no guarantee of improved performance across government. Also, deficiencies have been identified by the NAO in the tendering-for-contracts phase¹⁷ and concerns voiced about the degree of true competition and benchmarking that enters into the negotiation and renegotiation of PPP/PFI contracts.¹⁸

The papers in this issue

This issue of *Economic Affairs* includes five papers on PPP/PFI, from different perspectives. The first, by Professor Martin Ricketts, provides an admirably succinct account of the economic underpinnings of PPP/PFI, drawing on the seminal work of Ronald Coase (1937) on the boundary of the firm. Professor Ricketts explores the nature of transacting and contracting and draws out the lessons for the inefficiency of state provision of goods and services. At the same time, he does not neglect the difficulties experienced by PPP/PFI contracts. As so often in economic life, in making judgments on the public and private sectors the comparison is between two imperfect solutions to the economic problem. However, as Professor Ricketts concludes, public-sector provision is 'capable of obscuring the exercise of political and other special interests, and is unlikely to reflect purely commercial considerations. The nature of the inefficiencies induced through state action mutate as organisational structures change'. If Professor Ricketts is right, then the solution lies not in PPP/PFI but in the far greater distancing of politicians from economic decision-making best achieved through full-blooded privatisation.

The second paper, by Dr Mark Hellowell and Professor Allyson Pollock, looks in detail at the record of PPP/PFIs in the UK health sector. Recent years have seen the government desperately attempt to improve services in the NHS. After huge extra funding was injected, sometimes acting in partnership with the private sector, the results are bitterly disappointing. Dr Hellowell and Professor Pollock chronicle a litany of PPP/PFI failures and a desperately worrying future financial burden for unsuspecting taxpayers. As the medicine, PPP/PFI seems to be killing the patient. Surely the NHS deserves a more fundamental root and branch reform? The third study is by Dr Robert Jupe and is concerned with private capital and the railways. The railways were arguably one of the most controversial of the privatisations in the UK and Dr Jupe rehearses the many failures. Both the public and private sectors have difficulty in running an effective and efficient railway system with minimal subsidy.

The final two papers adopt an international focus. The study by Professor Erik-Hans Klijn of the record of PPPs in the Netherlands provides a cautiously favourable view of their potential for generating co-operative behaviour between the public and private sectors, although even so a number of schemes have taken much longer than intended to come to fruition. Lastly, Professors Graeme Hodge and Carsten Greve provide a timely overview of the growing interest in PPPs internationally and the different forms they take. They highlight both successes and failures and conclude that the empirical evidence of the performance of PPPs is insufficient both in terms of scope and rigour to come to firm conclusions.

Conclusions

What seems clear is that PPP/PFI is with us for the long term. Future cash-strapped governments, mugged by the experience of trying to deliver infrastructure services to an impatient public with an insatiable demand, will rely increasingly on the private sector, both for funding and provision. However, it is also clear that to date the experience of PPP/PFI has been far from a completely happy one. The challenge for economists and in particular public choice theorists is to come up with a means by which the public sector can procure effective and cost-efficient services from the private sector. And to achieve this without the distortions introduced by the endemic political self-seeing that distorts government in the public interest. This is quite a challenge.

1. Also, for an excellent study of the experiences with PPP internationally, see Hodge and Greve (2005).
2. Cited in de Pelet (1988).
3. However, the fact that the government finances a project does not necessarily reduce risk. The risk of project failure in the public sector is ultimately borne by taxpayers. Therefore, the lower cost of raising finance in the public sector results from the compulsory imposition of risk on the rest of us. Nevertheless, it is a fact that using conventional accounting government raises money more cheaply than private sector companies.
4. Jenkins (1995, p. 28).
5. 'Public Expenditure Control: The Sale of Assets and Other Financial Transactions', HM Treasury Paper, n.d.
6. See de Pelet (1988), op. cit.
7. PUK manages the Treasury Operational Taskforce overseeing PFI. Private finance units exist in major government departments.
8. For another study leading to similar conclusions see Shaoul *et al.* (2008).
9. In 2005 just over a half of PFI projects were on the government's balance sheet and counted as public sector debt. Following criticism from the Office of National Statistics, in recent years the government's ability to post PFIs 'off-balance sheet' has been curtailed. In turn, there is a suggestion that this has reduced interest in arranging PFI deals within government, including HM Treasury.
10. The difficulty inherent in incomplete contracts is amusingly illustrated by one NHS PFI for running services in a hospital. The contract specified that the private operator would provide toast for patients' breakfasts, but no one thought to include marmalade. Later the NHS trust agreed to pay extra for the marmalade and for litter clearance, which it had also neglected to specify in the original contract (Clark, 2005).
11. For example, HM Treasury (2006a).
12. Guasch (2004, p. 34).
13. HM Treasury (2006b).
14. HM Treasury (2008).
15. According to the National Audit Office (NAO), future payments across all PFI projects up to 2031–32 will amount to a colossal £91 billion at current prices (NAO, 2008).
16. NAO (2007a).
17. NAO (2007b).
18. NAO (2008).

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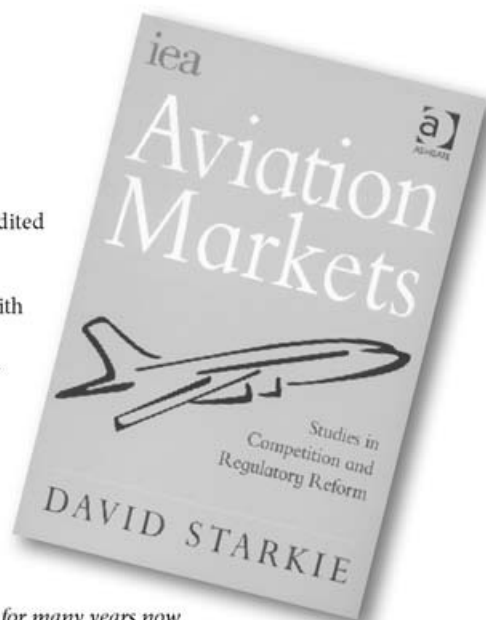
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