FINANCIAL STATEGY & Private Finance Initiative

Why PFI?

NICK CLARKE
To find out the Private Finance Initiative works in practice, this programme is going to look at a hospital PFI project which is currently under negotiation, and at Altcourse prison, where construction has just finished. The hospital example reveals the steps the public sector must take to get one of the projects off the ground, whilst at Altcourse the focus will be on how the private sector has responded to PFI. But firstly, it's important to understand how the state judges if a PFI project is better, that's to say offers better value for money than the public sector route, since it's on this calculation that the decision to proceed is based. The relative merits of the alternatives are determined by comparing total costs over the life of the project. The total cost of a conventional public sector capital asset procurement is made up of the large upfront costs of design and construction followed by payments of the project's operating expenses. Under PFI the picture changes, there is no need to find the initial capital as this is raised by the private consortium. Payments are then made for the service the consortium provides. These may be higher than previously, as they include an element of private profit as well as funding the consortium's finance package. The total cost in today's terms, known as the net present value, is simply the sum of these costs or cash flows discounted back to the present. At Altcourse prison the net present value of the PFI option is 247 million pounds, two-and-a-half million pounds less than the public sector route. Given that the public sector has the considerable advantage of cheaper debt; it's perhaps surprising that Private Finance projects can cost less than conventional procurement. In fact the private sector typically pay 30 percent more for their borrowings than the state and this extra expense is seen as one of the big drawbacks of using private finance for public projects. However there is an argument that says that the Government's real cost of capital is actually much higher.

MICHAEL HABIB
Now the reason why that is the case though is because when the Government borrows in essence what is happening is that tax payers are providing a guarantee to the lenders. Now that is not the case with the private sector, if a company is unable to service its debt in general the debt holders, the lenders, will lose some money. We simply have to look at the case, for example, of Euro Tunnel. Now this guarantee that is provided by tax payers is very valuable. There is a cost that is imposed on tax payers once they are called upon to do so. So it is misleading to compare, say, the ten percent cost of capital of a private sector firm with the 7 percent gilt rate. What one needs to add to this seven percent gilt rate is the guarantee provided by tax payers, and once one does so it is no longer clear that the cost of capital is lower to the Government than it is to the private sector.

NICK CLARKE
Misleading though it may be, the Government's lower cost of capital is used for making comparisons with the cost of private alternatives. So how does the PFI route manage to come in cheaper, as it appears to at Altcourse Prison? Part of the answer lies with the impact of transferring risks from the public sector to the private. Bearing financial responsibility if things go wrong is a strong incentive to the private sector to make sure that nothing does, made stronger still by the fact that they keep the benefits should things go better than expected. At Altcourse Prison the design and build risk was transferred to Tarmac Construction.

ROBERT OSBORNE
Whereas in a traditional contract it's possible to go back and look for extras, look for changes, and find more money in the case of this contract the ultimate risk of the out turn price was transferred across to us. This meant that we had to manage our approach such that we had to succeed, we had to put extra effort into the up-front planning, up-front engineering, to make

sure that we were not tempted to go back and ask for more money, and because we knew we wouldn't have got it anyway. The outcome was such that this building will be completed six months earlier than the contracted date, well within our cost budges and really a success for all parties.

CLARE DELMAR
PFI brings it one step further which says not only will you as the private sector take the risk of construction, which we've just discussed, but equally you will take the risk of operating it. So, for example, if there's an earthquake, and ten years from now the risk of actually repairing it and any injury and other cost that unfolds as a result of that catastrophic event, you the private sector will take. The cost implications, and the value for money that I now gain because I have passed off those risks, is actually very, very big, and that is one of the new features of PFI.

NICK CLARKE
At Altcourse it's now the consortium's responsibility to maintain the fabric of the prison, as well as ensuring the safety and security of staff and inmates, and they can face stiff financial penalties if they don't. The escape of a dangerous prisoner, for example, will net them a one hundred thousand pound fine.

ACTUALITY

The transfer of operating risks affects not just the operator member of the consortium but the constructor as well.

ROBERT OSBORNE
In a typical building design and construction contract you build it and then leave. The fact that we had the long-term responsibility for the operating of the concession as well meant that we had to weigh the balance between the design and construction cost, and the operation cost. For example, we see around us high technology fencing. This was put in at extra cost. The extra investment made in the high technology meant that the operator could reduce his staffing levels.

NICK CLARKE
The operator in this case is a subsidiary of security company, Group 4.

CHARLES ERICKSON
If you look at the costs of say, for example, two prison officers to pet petrol a perimeter fence for twenty-four hours a day, three hundred and sixty-five days a year, twenty-five years, and calculate the cost of that, and then estimate the costs of putting intelligence on the fence, more sophisticated alarm systems that will prevent an escape, the capital costs are much, much less than the long-term running of costs of patrolling that perimeter fence.

NICK CLARKE
The efforts consortia put into creating designs and operating systems that reduce risks and costs, such as this electronic key system, or the high technology fence, are all about winning the initial bidding competition and ensuring that if they do win, their returns are maximised over the life of the contract.