The Open University

Financial strategy & private finance initiative

Are PFI's a good deal?

Malcolm Prowle:
This talk is about the use of the Private Financial Initiative or PFI for short, in the delivery of public services such as health, education, transport etc both in the United Kingdom and other countries.

PFI is one of a number of ways in which the private sector of the economy gets involved in the provision of public services and has proved a very political controversial issue since it's inception in the early 1990’s.

Some see PFI’s as a means of bringing in scarce capital resources to public services and improving their physical infrastructure while at the same time improving the efficiency of service delivery. Others see the PFI as little more than the private sector ripping off the public sector by providing services at a higher cost than would be the case with purely public provision.

Let us therefore consider what the PFI involves. Like most organisations in all sectors of the economy public sector organisations need to invest continually in the development and maintenance of their service infrastructure. Often public sector organisations such as schools, local authorities or NHS Trusts in the UK face demands they cannot meet due to inadequate infrastructure and facilities and investment needs to be made to bring that infrastructure in terms of buildings, equipment, information technology etc up to appropriate standards.

Looking specifically at buildings, the traditional approach to developing such public service infrastructure would have been that the public sector organisation itself would design the type of building required to deliver it's services and would let a contract with a building contractor to construct the building according to the design. The public sector organisation would pay the building contractor from its own funds and would take possession of and operate the new building accordingly.

To finance such capital development public sector organisations could obtain funding from three main sources:

Borrowing: public sector organisations might borrow funds either from a government source or in a few cases from a commercial organisation such as a bank. Such loans would need to be repaid and interest would be charged.

Reserves: public sector organisations will often have accrued financial reserves which have been obtained from financial services made in previous years. These can be a source of capital finance for new buildings.

Grants: In some cases the public sector organisation might be awarded a government grant to cover design and construction costs.

For many years in the 1950’s and 1960’s insufficient attention was paid to maintaining public sector infrastructure with the consequence that many schools, hospitals etc were in poor, physical and visual condition. As part of an attempt to alleviate the situation the UK government, and many other governments around the world, have encouraged private investment in public service infrastructure through the mechanisms such as the PFI.

The PFI emerged as a logical outcome of the twin policies of the UK Conservative government of the 1980’s and 90’s, namely the need to curb public expenditure and to promote the market testing of in-house service provision against alternative private sector provision. In 1992 the Chancellor of the Exchequer announced a major change in the government’s attitude to the role of the private sector in the provision of public services. Many of the restrictions on the use of private finance to provide public services were removed and out of this the PFI developed.

So what essentially is a PFI project? Although PFI projects will always differ in scale and detail of configuration, the basic make up of a PFI project is as follows:

Firstly, the public sector organisation will identify a service need, which will require the construction of a new building. Examples might be: a new hospital, a new school or a new prison.

Secondly, the selected private sector partner will design, construct and finance the construction of this new building which meets the requirements of the public sector organisation in terms of service outputs. Often the private sector partner is not a single organisation but is a consortium, which comprises a bank, a construction company and a service company.

Thirdly, the private sector partner will also provide a range of support services such as cleaning, maintenance and security related to the new building.

Fourthly, the public sector organisation will pay the private sector partner an annual unitary payment, which incorporates a lease payment on the new building plus a charge for support services provided.

Fifthly, the public sector organisation will provide core services within the new building using it's own staff.

There are a number of key points to be noted about PFI projects.

Firstly it will be noted that the capital costs of construction will fall on the private sector partner and not on the public sector organisation. This has an immediate impact on public expenditure levels although clearly levels of public spending will be a little higher in future years because the public sector organisation must now make lease payments to the private partner for the contract period which typically would be twenty five years.

Secondly the associated financial liability for constructing the building will fall on the private partner and not the public sector organisation. Traditionally with most PFI projects both the asset value and the financial liability would appear on private sector balance sheets and not public sector balance sheets. However, changes to accounting practices probably mean the disposition will alter.

The PFI model described above is often referred to as “Design, build, finance and operate”, or DBFO for short. An essential element of a PFI scheme is that the private partner does operate some services to the building, a purely design, build, finance model is not acceptable.

Fifthly, under a PFI scheme although the private partner will provide some support services the core services will still be provided by the public sector. Typically this might mean doctors and nurses in a health PFI project or teachers in a school’s PFI project. However, the definition of the term “core services” is not precise and the split of service provision between public and private organisations is open to negotiation.

Sixthly, before a PFI project can go ahead, it must be compared to the equivalent project which might be funded from traditional public finance methods described earlier. This is termed the “public sector comparator”. For a PFI project to go ahead it must be able to demonstrate that it will provide better value for money in the use of public monies than the equivalent public funded project. This might come about because of greater private sector efficiency or greater innovation by the private sector in service delivery such as the use of enhanced CCTV systems in PFI financed prisons. It may also involve transferring significant project risks away from the public sector to the private partner. An example here might be the risk of a construction cost over-run. However, this is a controversial area and many will argue that many PFI projects did not demonstrate value for money or risk transfer but the projects went ahead anyway because there was no alternative source of capital finance available.

Since it's inception the PFI route has delivered over forty billion pounds of public sector infrastructure in the UK and PFI is officially one of the government's main instruments for delivering higher quality and more cost-effective public services. Its aim is to bring the private sector more directly in to the provision of public services with the public sector as an enabler and where appropriate, guarding the interests of the users and customers of public services. It is not simply about the financing of capital investment in services but about exploiting the full range of private sector management, commercial and creative skills.

However, the future of PFI is uncertain for a number of reasons: the fact that a huge amount of investment has already been made in the public sector infrastructure through the PFI and future levels of investment might need to be lower; the impact of the recent financial and banking crisis and the ability of private partners to obtain finance; the impact of economic recession on overall spending levels; the impact of changes in accounting practices and inability of governments to show financial liabilities for projects on private sector balance sheets; the attitude of a possible new government after the next election in 2010.

Nor is PFI any longer unique to the UK. While the PFI was invented in the UK after a slow start other countries are getting deeply involved. Experience in the UK has shown the economic conditions conducive of PFI use are: a public sector's infrastructure in need of modernisation; a reluctance to increase taxes to pay for it by conventional means and a political environment in which governments wanting a brake on public sector borrowing, probably a situation in which just about every country in the world now finds itself. South Africa, the Netherlands, Portugal and others began using PFI especially for transport projects but also, in the case of South Africa, to build new prisons. The difference today is not just that PFI is rolling out to more countries but also it's being used with a broader range of public service activities. While Portugal has used PFI for road building for some years it is now adopting it for hospitals too. Norway is using PFI for roads and Denmark to build bridges. In Canada the State of Vancouver uses PFI for road and rail. And Japan, the Australian States and the Irish Government are adopting the PFI approach for a wide range of infrastructure projects including transport, health and education.

However, whatever the future holds for the PFI itself it seems that in the UK the private sector will continue to have a strong and continuous involvement in the delivery of public services in some form or another.