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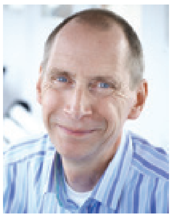

The UK pioneered the use of private investment in public infrastructure but progress has stalled in recent years. Richard Byatt reports on reforms to PFI and the experience in other countries

The Private Finance Initiative (PFI) was established over 20 years ago by the Conservative government of John Major. The twin drivers were a need to reduce public spending and a belief that the private sector could deliver major projects more efficiently.

Under PFI the private sector finances, builds and operates public infrastructure such as schools, roads, prisons and hospitals, and provides facilities management through long-term concession agreements. These agreements are designed to transfer risk to the private sector in return for payments over the concession life, usually at least 25 years. Payment is only made if services are delivered according to the requirements of the agreement.

PFI has evolved over the years in response to shortcomings and criticism. Many early schemes were refinanced more cheaply once the risky construction phase was completed, resulting in "windfall" gains for the consortia behind them. Contracts are now written to ensure the public purse shares in refinancing gains and under recent reforms (see below) the government will take an equity stake in projects.

According to the PPP Forum the overall cost of financing a PFI project has been typically about 2.25 per cent per annum, more than that of a traditionally-procured project. This is because the government's cost of finance is less than the private sector.

Widely reported instances of excessive charges for simple tasks, such as installing new electrical outlets, has resulted in calls for more transparency and predictability in contracts. In the mid 2000s, dissatisfaction with delivery led to a change in Government policy to allow "soft" facilities services, such as catering, cleaning, maintenance and security to be excluded from core PFI arrangements. These services could be procured separately and more conventionally. Under the reforms this is now the default position.

The latest Treasury PFI projects summary (to March 2012) shows 717 current PFI projects, with a total capital cost of £54.7bn. The largest number of projects, 166 with a capital cost of £7.7bn, were for the Department for Education. The Department of Health had the highest expenditure, with 118 projects costing £11.6bn. The projected capital spending by the private sector under PFI contracts for 2013-14 is £1.4bn. PFI unitary charge payments are expected to total £9.3bn in 2012-13.

PFI was born in the UK and Australia but the principles have been adopted in many other countries, including in Europe (France, Spain, Portugal, Germany, Netherlands, Sweden) and in Canada, Australia and South Africa. Programmes are also in development in the USA, Eastern Europe, Turkey, and South East Asia. Outside the UK the term public private partnership is preferred and the abbreviations PPP and P3 are more commonly used.

PFI reform in the UK (PF2)

After 2008, the flow of new PFI projects slowed as the UK economy weakened. The new coalition government elected in 2010 has indicated that there will be more focus on investing in new economic infrastructure (energy, broadband and transport) rather than social infrastructure (hospitals, schools and prisons). In 2010 the Government abolished the PFI credit regime to create a level playing field for all forms of public procurement.

In 2011 the Government initiated a fundamental reassessment of PFI. HM Treasury's report at the end of 2012, A new approach to public private partnerships, acknowledged that the Private Finance Initiative "has become tarnished by its waste, inflexibility and lack of transparency" and set out a new approach to involving private finance in the delivery of public infrastructure and services.

The key elements of the PF2 approach are:

- Government to become a minority equity co-investor in projects
- Private sector required to provide actual and forecast equity return information
- Departments encouraged to establish a central procurement unit
- Maximum 18 months allowed for competitive tendering phase of PF2 projects
- New standard documentation, including new procurement and contract guidance; a standard facilities management service output specification and a pro-forma payment mechanism for accommodation projects.
- Greater retention and management of certain risks by the public sector

The most significant change for the FM market has been the mandated removal of soft services from contracts "other than where exceptional integration benefits exist which are essential to achieving project outcomes".

Removing soft services and creating "discretionary" services may bring flexibility but it could also increase complexity say some commentators. Each project will need an "interface protocol" to set out how the parties will work together, says Olivia Blessington, an associate with law firm Clyde & Co.

The review also responded to concern that public sector procurement skills need improving. Paul Deighton, previously chief executive of the London Organising Committee of the Olympic and Paralympic

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Games (LOCOG), was appointed commercial secretary to the Treasury at the beginning of 2013 and led a detailed assessment of Whitehall's ability to deliver infrastructure.

The first programme to use the new PF2 model will be the £1.75 bn privately financed element of the Priority Schools Building Programme. The Treasury is working with other departments, including Health and Defence to assess which future projects are eligible for PF2.

Drafts of the new standard form services output template, pro forma payment mechanism, and shareholder arrangements have now been published for consultation.

Around the world

PPP and its variants in other countries are not without their critics and problems but generally speaking this type of procurement seems to have gained wider acceptance, more quickly outside the UK.

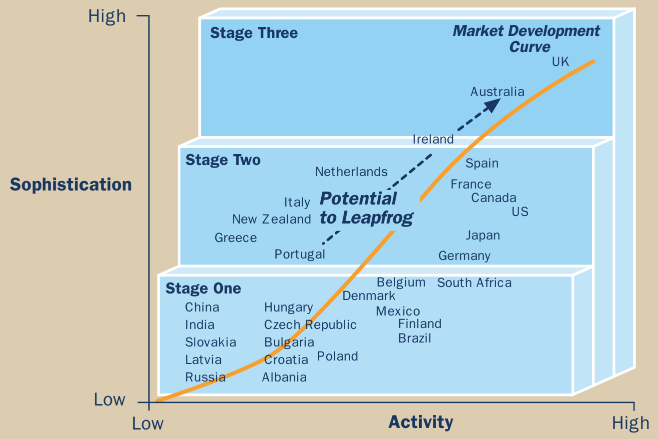
An early report by Deloitte (Closing the Infrastructure Gap) found that "countries remain at vastly different stages of understanding and sophistication in using innovative partnership models." The consultants proposed three distinct stages of PPP maturity (see diagram).

"Countries at earlier stages of PPP development could benefit from the opportunity to learn from the trailblazers who have moved to more advanced stages," says Deloitte, citing the UK for schools, hospitals and defence facilities; Australia and Ireland for roads; and the Netherlands for social housing and urban regeneration.

"Such countries can adopt from the outset some of the more flexible, creative and tailored PPP approaches now being used in trailblazer countries. This approach would allow them to move up the PPP maturity curve more rapidly and leapfrog to more advanced stages of maturity."

A survey undertaken last year by

PPP Market Maturity Curve



Stage One

- Establish policy & legislative framework
- Initiate central PPP policy unit to guide implementation
- Develop deal structures
- Get transactions right & develop public sector comparator model
- Begin to build marketplace
- Apply early lessons from transport to other sectors

Stage Two

- Establish dedicated PPP units in agencies
- Begin developing new hybrid delivery models
- Expand and help shape PPP marketplace
- Leverage new sources of funds from capital markets
- Use PPPs to drive service innovation
- PPP market gains depth—use is expanded to multiple projects & sectors

Stage Three

- Refine new innovative models
- More creative, flexible approaches applied to roles of public & private sector
- Use of more sophisticated risk models
- Greater focus on total lifecycle of project
- Sophisticated infrastructure market with pension funds & private equity funds
- Public sector learns from private partner methods as competition changes the way government operations function
- Underutilized assets leveraged into financial assets
- Organizational & skill set changes in government implemented to support greater role of PPPs

Partnerships Bulletin with Deloitte asked representatives of 70 international PPP companies about global markets. The majority of respondents consider "consistent political support of PPPs to be the biggest challenge facing the industry." Canada was considered to be the most attractive market, with its strong pipeline and supportive legal system.

Service Works Group has implemented performance management software for PPP schemes in several countries, including the UK, Canada, Australia, Malaysia and the Middle East. MD Gary Watkins says the prime reason for the success of PPP in Canada is broad-based support and transparency: "P3s have local and federal government support and there is generally greater transparency," he says. "There's more effort to involve the communities in which these projects are based and to explain the schemes."

Partnerships Bulletin say there is a "massive difference" between the Canadian approach and current thinking in the UK. Indeed, Canada today seems reminiscent of the UK's "only game in town" phase, with the Canadian High Commissioner Gordon Campbell saying: "Every project will first be a PPP, and if it can't be made to work, only then will other options be looked at."

According to Paul Jarvis, managing editor of Partnerships Bulletin, Canada tends to include soft facilities services within its P3 contracts, while Australia has generally left them out but is now starting to bring them in, effectively going in the opposite direction to the UK.

One of the most frequent suggestions raised during the UK Government's review of PFI was greater centralisation and improved professionalism of public sector procurement. International examples of centralised procurement units in countries such as Canada were held up as examples that the UK should follow.

The recent UK Government Spending Review said: "Learning the lessons from the successful delivery of major projects such as the Olympic Games and Crossrail, the Government will introduce a new presumption that significant economic infrastructure projects and programmes should be undertaken by specialist delivery units with commercial expertise, reflecting private sector best practice."

PFI and, it could be argued, PF2 have not really addressed the refinancing issue. In Australia projects may be less controversial because they are often on a transfer basis, with assets eventually returning to the public sector.

The United States is not yet a mature PPP market according to Watkins. Although it came top of Partnerships Bulletin's medium to long-term emerging PPP market ranking, it also came second (behind the UK) in the list of countries with the greatest challenges for its approach to PPP. "The market has long been criticised for its failure to translate its huge potential into projects on the ground," commented Partnerships Bulletin. "It appears the feeling from many companies is that, while it is an important place to be, opportunities are likely to remain limited at least until the federal government gives states greater encouragement to use the model."

Other markets

Those countries still deep in recession and debt are not natural PPP territory. In Portugal and Greece for example, opportunities for private investment are likely to come with asset privatisation, rather than new infrastructure. Hospitals remain the only area of PPP growth in Italy. By contrast, Ireland is seeing renewed PPP activity. The country's Department for Education and Skills signed its first PPP deal since June 2010 last November.

The Philippines has a similar PPP model to the UK and is open to investment, with a big pipeline. Indonesia has launched seven or eight projects, with three reaching financial close. Malaysia and Thailand are in the early stages of PPP.

Further afield, the schools market in India has potential but the Government has been slow to react and it is hard for international players to get involved. According to the Partnerships Bulletin/Deloitte survey, one tactic that is becoming popular is for companies to partner with a smaller local contractor.

The global economic situation, limited funding, changing attitudes to risk and well-publicised operational problems have all meant that PPPs are no longer seen as a panacea. But quietly, around the world, they are being adopted as one tool for closing the infrastructure gap.

The UK exported the concept to many countries, it can now import some of the best practice in taking PPPs to the next stage of their development.

Richard Byatt is an account director with Magenta Associates and former public affairs director at the BIFM. FMJ acknowledges the assistance of Partnerships Bulletin in researching this article www.partnershipsbulletin.com