European Investment Bank

PFI Projects seek partners

Nicholas Timmins, Financial Times, FEBRUARY 23 2009

Once, it looked to be the closest thing to a finance minister's free lunch. Enlist the private sector to put up the money and build new schools, roads, hospitals, barracks and prisons. Devise a financing structure that operates like a cross between a mortgage and a full repairing lease, so that buildings are properly maintained throughout their lives – and are so well constructed that this is cheap.

Transfer a good chunk of the risks of operating the services to the private sector. Finally – in some countries at least – enjoy the fact that many of these projects do not appear on the government's balance sheet. Result: the public gets a host of improved services now, to be paid for by taxpayers over the decades to come.

Turning over the design, construction, financing and operation of big infrastructure projects to the private sector was an idea dreamt up in Australia in the late 1980s, starting with railway stations and toll roads. But it was the UK that embraced it most enthusiastically in the early 1990s under the auspices of the private finance initiative (PFI) – to the point where more than 800 deals have been signed with a capital value of about £68bn ($99bn, €78bn). Public sector commitments to pay for these, in terms of capital, maintenance and services, now total in excess of £215bn, stretching until 2032.

The off-balance-sheet nature of the projects, together with evidence that PFI has tended to deliver hospitals, schools, roads and other projects to time and budget, caught the eye of governments and financial institutions around the world. Backed by bodies such as the European Investment Bank, the use of private finance for public infrastructure – using PFI-type contracts or variants on them – has been adopted in a host of European countries, South Africa, India, the US and elsewhere. In some countries, notably Canada, some practitioners argue that it has proved even more effective than in the UK.

Today, the party may not be over for the private finance initiative. But it is far less champagne-fuelled than it was.

By the end of last year, the bond market to finance PFI deals had vanished; bank funding, likewise, had dried up. In the UK, just a dozen small PFI projects were signed off in the second half of 2008. Over the whole year, just 34 deals were finalised – about half the annual rate seen over the previous decade.

Since December, some banks have returned to the market. But there are fewer than there used to be, according to PFI practitioners, so less money is available overall – quite possibly not enough to fund the billions of pounds' worth of past, just one or two banks, even on deals involving hundreds of millions of pounds, would provide the debt and then syndicate it out to others. Now, with the banks facing heavily competing demands for whatever lending they are prepared to undertake, few are willing to put in more than £30m-£50m on a deal. That requires large clubs of them to be assembled to fund bigger projects. That in turn takes time, costs money and runs the risk that banks will pursue the projects with less enthusiasm for fear that if some drop out, the deal will founder.

A recent survey of 20 banks by PwC showed a significant number wanting to lend only for seven or eight years, or seeking structures that would allow some form of refinancing around that time. That further complicates the deals and ill suits the 20- to 30-year timescale of many projects.

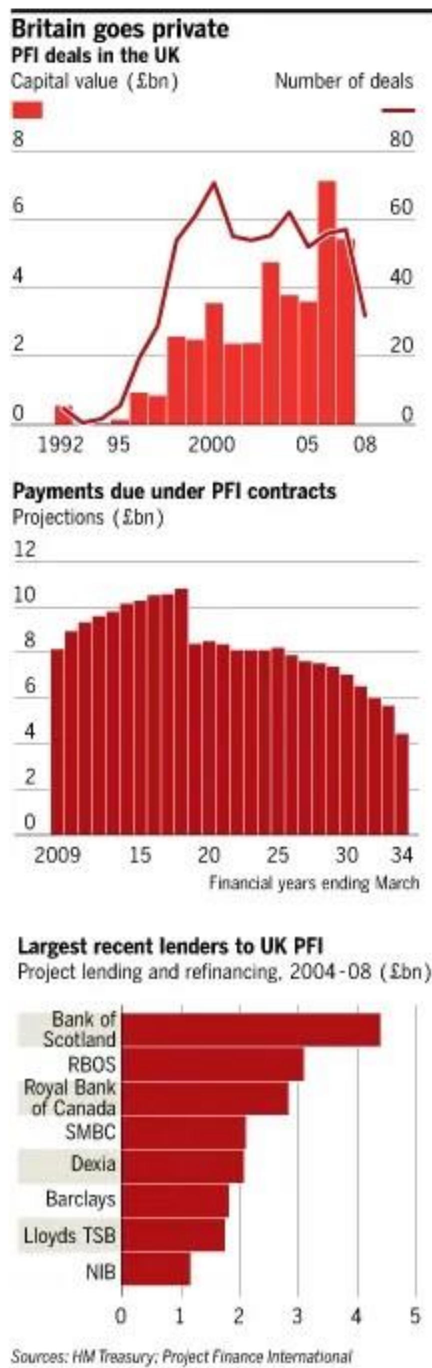
Malcolm Paul, chief executive of WSP Group, an engineering consultancy, says the financial problems of banks have left them much more wary of taking on the credit risk of PFI projects. "There used to be a partnership between the service deliverers and the banks in terms of putting together a PFI package," he said. "But the problems that the banks have mean they're trying to pass on risks to us that we don't think we should have to take on, so you end up with a jostle."

Since the turn of the year, some smaller projects, including a number of schools, have reached financial close along with one bigger one – a £320m project in Scotland to turn the A80 road into an M80 motorway. That was signed "against all the odds in the current financing market", according to Richard Threlfall, the KPMG partner who advised Transport for Scotland.

Finalising it required the EIB, using taxpayers' money, to break its normal rule that it will not fund more than half the cost of a scheme. "The question," Mr Threlfall says, "is whether there will ever be a deal of this type again, or whether it is an indication that long-term project finance is not dead, and we can start looking forward to a recovery."

"Not yet" seems to be the answer, for the bigger deals at least. Some 19 banks are in negotiation over the £1.25bn debt financing needed to widen the M25, London's orbital motorway. But the Highways Agency has already had to promise to inject taxpayers' money if some of them drop out.

With £4.5bn worth of projects including the M25 and £1bn worth of schools needing to raise finance this year – and with central and local government facing EU fines if the waste projects do not get built – the Treasury has promised to do however. The idea is “ridiculous”, says Philip Hammond, Treasury spokesman for the opposition Conservatives. “If you take the private finance out of PFI, you haven’t got much left,” he says. PFI is meant to transfer completion and operational risk to the private sector, “and if you transfer the financial risk back to the public sector, then that has to be reflected in the structure of the contracts.



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“The public sector cannot simply step in and lend the money to itself, taking more risk so that the PFI structure can be maintained while leaving the private sector with the high returns these projects can bring. That seems to us fairly ridiculous.” Indeed, part of the risk transferred to the private sector has already come back to the taxpayer. Equity, not bank lending, takes the first hit when a project goes wrong. But in recent years some of the biggest lenders to PFI projects have been the Bank of Scotland, Royal Bank of Scotland and Lloyds TSB – banks in which the taxpayer now holds a large stake.

If the short-term problem is how to get private finance flowing again, there is also a longer-term one. Accounting organisations have argued for years that if the taxpayer was going to have to pay for these projects, the liability should be acknowledged. Now, the government has promised to bring PFI back on to its books.

That will have the beneficial effect that deals will only be done where authorities are convinced they offer better value for money than conventional procurement. But from 2011, the Treasury has already announced a cash freeze in capital expenditure – and even that may prove to be optimistic given the recent large deterioration in public finances.

According to David Heald, professor of accountancy at Aberdeen Business School, once PFI projects – of which there are £20bn worth in the pipeline - are back on the books, they will count as capital expenditure within that freeze. “In terms of public spending, it won’t matter whether a new hospital or school is PFI or nonPFI, it will score in the same way. They will count as capital investment.”

All that, says John Tizard, director of the Centre for Public Service Partnerships at Birmingham university, makes the outlook for public infrastructure look “pretty bleak”, whether it is publicly or privately financed.

That is likely to intensify the search for approaches that use some of the techniques of PFI – better risk assessment and incentives to reduce the lifetime cost of a project – without the full additional cost of private finance. The Treasury has aired a number of ideas for that. PwC concludes that “in principle” this is possible but “it is not easy to see how they could ever fully match the disciplines flowing from externally provided finance”.

Right now, however, the Treasury’s concern is more immediate: how to provide big existing projects with the public money they need to keep them on the road. Otherwise, for instance, almost the first thing participants and spectators who fly into

London for the 2012 Olympics might encounter is a dauntingly long tailback on the M25.

Some 860 projects with a capital value of £68bn ($99bn, €78bn) – including the largest hospital building programme in the history of the country's National Health Service – have been launched, mostly since 1997. More than 650 are operational.

In transferring construction risk to the private sector, PFI has broadly worked. The overwhelming majority of projects have come in on time and on budget. Most delays have been small. With a tiny number of exceptions, the private rather than the public sector has taken the hit when costs have overrun or builders have run in to trouble.

But the question of whether PFI represents overall value for money may never be definitively answered. First, these are usually 25 to 30-year contracts. The earliest have generally been operational for only seven or eight years. In addition, in many sectors, PFI has been the only game in town – so there are next to no conventionally financed projects available for comparison.

MPs on the House of Commons public accounts committee have repeatedly complained that the "commercial in confidence" nature of the deals makes it impossible for them to judge value. The National Audit Office has tried to do so but has struggled to reach a clear verdict.

The audit office says that when necessary changes are made to operational projects, the costs can be horrendous. "Soft services" such as cleaning and catering are re-tendered every five years or so in an attempt to ensure value for money, but it is unclear if that is being achieved.