

# THE FUTURE OF PRIVATE FINANCE INITIATIVE IN THE UK: VALUE FOR MONEY FROM MAIN CONTRACTORS' PERSPECTIVE

<sup>1</sup>Richard Ellidge and <sup>2</sup>Adebayo Oladapo

<sup>2</sup>Grenfell-Baines School of Architecture, Construction & Environment, University of Central Lancashire, Preston, UK

<sup>1</sup>RJellidge@uclan.ac.uk; <sup>2</sup>aaoladapo@uclan.ac.uk

## Abstract

Private Finance Initiative (PFI) is commonly used by the UK government to procure infrastructure and other facilities. While UK government functionaries and interest groups such as the Confederation of British Industry and others extol PFI as an effective public sector project delivery tool, groups like the British Medical Association and UNISON claim that it allows contractors to profiteer at public expense without providing value for money. The aim of this study was to investigate the opinions of main contractors in the UK construction industry to get a balanced view of the PFI debate. The study involved interviews with representatives of three contractors who have vast experience in the UK PFI/PPP market. The findings showed that contractors believe that their profits are commensurate with the level of risks they assume and the quality of work they produce to provide long-term value for money to clients. They stated that the cost of PFI projects could generally be reduced through a combination of greater risk retention by the public sector, more standardisation of project documentation and output specifications, a reduction in tender costs and periods, and greater integration between contractors, facilities management (FM) providers and owner operators

**Keywords:** Private finance initiative, value for money, main contractors, UK.

## INTRODUCTION

Private finance initiative (PFI) is a form of public private partnership (PPP) which liberalises the way public services are procured. According to Broadbent *et al.* (2003), this approach opens up the provision of public services so that they can be procured not only from public sector organisations but also from both the public and private sectors in some form of partnership between the two sectors. Under the PFI arrangement, the public sector engages the private sector to finance, design, construct and operate a facility to provide a required service to satisfy public demand. Typically, a private sector contractor or consortium of contractors constitutes a special purpose vehicle (SPV) which enters into a contract with a public sector organisation to provide a service or facility. The SPV is usually made up of private sector investors, a construction company, a service provider and often a bank (Zheng *et al.*, 2008). This arrangement has been touted as the solution to years of under-investment in the provision of public infrastructure and services. It is therefore not surprising that successive governments (both Labour and Conservative) in the UK have embraced the system (Froud and Shaoul, 2001). In the UK, PFI has been used for a variety of projects including the Channel Tunnel rail link and the Parc Prison in Bridgend, Wales (Kirk & Wall, 2001). It is used extensively in the UK health sector under the National Health Service (NHS).

While UK government functionaries and interest groups such as the Confederation of British Industry and others extol PFI as an effective public sector project delivery tool, groups like the British Medical Association and UNISON claim that it allows contractors to profiteer at public expense without providing value for money. In recent times, PFI has been severely criticised in the media for failing to provide value for money to the public sector. This stems largely from the public perception that PFI is a step towards privatisation (Pollock *et al.*, 2002) and that it allows the private sector to profiteer at the

expense of the public sector (Hellowell & Pollock, 2009). These criticisms, coupled with some of the measures taken by the current coalition government in the UK since its inception in 2010, have cast some doubts about the future prospects of PFI in the UK. According to Adair *et al.* (2011), in one such measure, the coalition government reviewed and withdrew funding for a number of proposed PFI projects while others were allowed to continue only within tighter financial controls.

In this debate, very little has been heard from contractors against whom are directed most of the anti-PFI criticisms. It is against this that this study investigated the opinions of 3 major PFI contractors in the UK construction industry to get a balanced view of the PFI debate.

### **THE ORIGIN, EVOLUTION AND CURRENT USE OF PFI IN THE UK**

Before the 1990s, UK governments were not keen on the idea of allowing private capital to finance public sector projects. This position was entrenched in the Ryrie Rules which were established in 1981 by the National Economic Development Council (NEDC) under the leadership of Sir William Ryrie. In February 1998, the rules were revised to allow for the introduction of mixed public-private sector funding and partnership schemes in public sector projects. According to Allen (2003), the two fundamental grounds for private finance in public sector projects were to offer cost effectiveness and for the government to include them in public expenditure planning. The Ryrie rules were replaced in 1992 by the Private Finance Initiative proposed by Norman Lamont. Lamont, the then Chancellor of the Exchequer, emphasised that the operation of PFI should ensure a sensible balance between the need to protect taxpayers' interests and taking full advantage of investment opportunities in the public sector (Allen, 2003).

PFI was introduced to achieve closer public-private sector partnerships in project delivery with the key aim of transferring risks from the public sector to the private sector to ensure value for money. When Kenneth Clarke was the Chancellor of the Exchequer in 1993, he decided to develop it further by creating a Private Finance Panel (PFP) whose role was to encourage the participation of both sectors in PFI and identify areas of need in the public sector where the private sector could help (Allen, 2003). The use of PFI in the UK has undergone several reviews by governments since the Clarke years. According to Allen (2003), the Bates review of 1997 made 27 recommendations, including the creation of a task force within the Treasury Department to help foster PFI expertise in government. Yet another review by Sir Bates in 1999 led to the creation of Partnerships UK which was charged with the responsibility of sourcing development funding for PFI projects.

Since its introduction, PFI has been a major procurement option for infrastructure and public services in the UK. According to Adair *et al.* (2011), the capital value of the PFI market in the UK attained a peak value in 2006 with contracts signed worth about £7b. It has been increasingly used by the UK government especially in the education, health, transport, roads and prison service sectors (HM Treasury, 2009). A report from Partnerships UK (2010) documented that since its launch, PFI had successfully procured more than 900 projects valued in excess of £70 billion. A report by HM Treasury (2012) showed that the total value of the portfolio of ongoing PFI projects across UK government departments stood at over £54 billion as at March 31, 2012. The Department of Health had the largest share (about 21%) while the Department for Energy and Climate Change had the least (about 0.01%)

The policies of the current Coalition government have cast some doubts on the future prospect and role of PFI in the UK. Adair *et al.* (2011) highlight three major policy documents published by the Coalition government regarding capital spending and infrastructure development which have far-reaching implications for the PFI market. These are the Emergency Budget of June 2010, the Comprehensive Spending Review of



October 2010 and the National Infrastructure Plan of October 2010. According to Adair *et al.* (2011), the Comprehensive Spending Review indicated government plans to limit the incentives granted to local authorities to use PFI as a procurement option. One of the first reported casualties of these policy changes was the Building Schools for the Future (BSF) PFI scheme in Lancashire. It has been reported by Chan (2010) that some projects under the BSF scheme were cancelled in Oldham, Lancashire, in June 2010 by the Coalition government

### VALUE FOR MONEY (VfM) IN PFI PROJECTS

According to Grimsey & Lewis (2005) VfM is defined by UK's Office of Government Commerce (OGC) as the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user's requirement. In the context of public projects, VfM is simply "the effective use of public funds on a capital project" (Grimsey & Lewis, 2002). This requires the procurement of higher quality public infrastructure and services at a lower and is the main justification for the use of PFI by the public sector ( Siemiatycki & Farooqi, 2012). According to Grimsey and Lewis (2005), the OGC's requirements for VfM would seem to be that

- projects be awarded in a competitive environment
- economic appraisal techniques, including proper appreciation of risk, be rigorously applied, and that risk is allocated between the public and private sectors so that the expected value for money is maximized and
- comparisons between publicly and privately financed options be fair, realistic and comprehensive.

Glynn (1985) cited in Demirag & Khadaroo (2008) defined value for money in terms of the 3 Es of economy, efficiency and effectiveness. According to Demirag & Khadaroo(2008) , Glynn defined the 3Es as follows:

- Economy is acquiring resources of an appropriate quality for the minimum cost. This requires minimising the cost of resources uses while aiming for the highest possible quality (Kloot, 1999 cited in Demirag & Khadaroo, 2008 ).
- Efficiency is obtaining maximum output is obtained from the resources devoted, or conversely, that a minimum level of resources is devoted to a given level of output.
- Effectiveness is ensuring that the output from any given activity is achieving the desired results

With respect to PFI projects, Akintoye *et al.* (2003) described VfM as changing in meaning throughout the project stages. At the development stage it is regarded as the optimum combination of quality and cost, at procurement stage it is the difference between the PFI option and the public sector comparator and at the operational phase, it is measured in terms of the performance of the services. VfM in PFI is measured In terms of the difference between the public sector comparator (PSC) and the PFI Option. The PSC is an estimate of the costs of the conventional public sector procurement alternative (Demirag & Khadaroo, 2009) and takes into account risks which remain with the public sector and those which are transferred to the PFI contractor (Heald, 2003; Broadbent & Laughlin, 2005). If the PFI option costs less, then value for money is demonstrated.

The Office of Government Commerce (OGC), cited in Ruane (2010), asserts that the aim of PFI is to deliver better value for the taxpayer by challenging projects on deliverability, affordability and value for money. Allen (2001) argues that PFI provides better value for money by transferring risk, having lower construction costs, lower operating costs and more efficient maintenance in the long term.

These views are highly contested due to the exceptionally high cost of finance entailed in PFI (Liebe & Pollock, 2009). Hellowell and Pollock (2009) also contend that profiteering by private investors in PFI is evidence of bad value for money for the public sector. On the other hand, Allen (2003) believes that the main benefit of transferring risk to the private sector may be eroded as risk and reward go hand in hand; the higher the perceived risk carried by the private sector, the greater the risk premium that will be charged by private sector investors to compensate for the risk exposure. This will seem to suggest that transferring risk to the private investor may not necessarily yield benefits to the public sector client. Despite the many claimed advantages of PFI contracts in regards to VfM, critics such as Broadbent and Laughlin (2005), Heald (2003), Pollock, *et al.* (2007) and Shaoul (2005) argue that assessment is difficult due to the commercial confidentiality of the contractual process and question the validity of the value for money methodology. Liebe and Pollock (2009) have also contended that the cost of finance under PFI is higher compared with conventional procurement. In addition, they provide evidence to show that returns to private sector partners in PFI were about 2.4% above what they could earn under conventional investments. This seems to be the basis of the contentious issue and criticisms that the private sector is profiteering in PFI (Dawson, 2001; Davis & Dowdeswell, 2003).

### AIM OF THE RESEARCH

Opposing views on value for money in PFI projects in the UK have been discussed in the previous sections. It is clear from these discussions that the debate has not featured the views of contractors at whom most of the criticism are directed. It is against this background that this research sought to investigate the views of 3 of the UK's largest PFI contractors on the question of value for money for public clients *vis-a-vis* the return on investment to contractors. The aim of the study was to identify the key elements that promote or diminish value for money in PFI projects the UK from contractors' perspectives.

### RESEARCH METHODOLOGY

The researchers adopted the interview method to obtain qualitative data. Using a convenience sampling approach, the researchers selected three of the ten major UK PFI contractors based on the accessibility and availability of the contractors to participate in the study. In each firm, a key member with at least ten years of experience in PFI projects was interviewed on issues relating to the perceptions of contractors on the value they provide for their public sector partners and the profit they make in PFI projects. Details of the issues discussed in the interviews are shown in Table 1.

*Table 1: Issues and questions in the interview*

Issues	Questions
<i>Contractors' perception of VfM</i>	<ul style="list-style-type: none"> <li>• <i>What is your interpretation understanding of "Value for Money" on PFI projects?</i></li> <li>• <i>What value do main contractors bring to PFI projects that the public sector would not be able to offer in a traditionally procured project?</i></li> <li>• <i>What improvements could be made to the PFI process to drive out best value for money?</i></li> </ul>
<i>Risk allocation and VfM</i>	<ul style="list-style-type: none"> <li>• <i>What particular risks do contractors bear on PFI projects that they would not normally take on in other forms of contract?</i></li> <li>• <i>Do the risks contractors take on justify the allegedly high returns reported in the media?</i></li> </ul>
<i>Profitability and profiteering</i>	<ul style="list-style-type: none"> <li>• <i>The Private sector has been accused of profiteering on PFI</i></li> </ul>



projects. What is your opinion on this and what have been the major issues that affect profitability for contractors on PFI schemes in your experience?

- Much has been said in the press about the bidding costs and extended tendering period on PFI projects. What are your experiences of this and how does this compare to other forms of procurement?

### The Sample

As stated earlier, the three contractors selected were among the top 10 PFI contractors in the UK in terms of their volume of work and turnover. Table 2 provides the contractors' and interviewees' backgrounds.

**Table 2: Profile of contractors and interviewees**

	Contractor A	Contractor B	Contractor C
Contractor Size	Global group turnover circa £4b per annum, 15,000+ employees. Design & build and engineering contractor with financial investment opportunities	Global turnover circa £7 billion per annum, 18,000+ employees. Fully integrated, international property and infrastructure group. Has own facilities management division.	Turnover circa £11b per annum. Circa 11,000 employees in the UK alone. Leading integrator of complex, sophisticated and innovative infrastructure projects.
Contractor's PFI Experience	Leading Health and Education UK PFI Contractor heavily engaged in UK and Australian Government programmes. Experience in Infrastructure projects including rail, road and airports	Experience in healthcare, education and infrastructure projects including waste. Built, managed and operated 8 major PFI hospitals including £420m redevelopment of a hospital. Education schemes include £332m building schools for the future scheme.	Operate a portfolio of long-term PPP concessions in the UK, primarily in the education, health and roads/street lighting sectors. Broad range of capabilities in construction, civil engineering and mechanical & electrical engineering services.
Respondent's Role	Project Manager	Cost Estimator Planner/Bid	Bidding & Design Manager
Respondent's Years of Service	19	14	12
Respondent's PFI Experience	Various hospitals and education projects ranging from £22m to £295m in value. Mixture of construction and project management experience	Worked on £420m hospital redevelopment and £250m multiple education schemes. Involved in bidding the projects, pricing the schools and managing design through the tendering period to financial close of the projects with the SPV.	Varied experience in infrastructure and education projects. Began career as a design manager before moving into bidding department putting together bid documents for several PFI bids.

## DATA ANALYSIS AND RESULTS

### Interview responses and analysis

#### Question 1

What is your interpretation of "Value for Money" on PFI projects? From a contractor's perspective, is the focus on providing best value for money for the public sector client or more on getting the job done on time and to budget?

#### Responses to Question 1

The main issues identified by the respondents to be determinants of VfM are integration of design, construction and FM functions, competitive tendering and the need to balance high capital costs with low operational expenses. All 3 respondents shared the same basic view of VfM. They felt that if they were producing the best product, fit for its intended use for the client without compromising on quality, then they were delivering value.

Respondent C regarded 'Fit for purpose' as a very important concept, as it can affect the performance of the project in relation to the output specification. Poor performance can reduce profits for the contractor through reduction in the unitary payments, and usually further maintenance and replacement costs will follow on in the operational phase of projects.

Respondent A made the point that the actual construction costs are pretty much irrelevant on some larger schemes. Their explanation for the construction phase having less importance was that the profits made on the construction element are minimal in comparison to the unitary payments received from the client and potential re-financing costs. This was echoed by Respondent B who stated that the best product would usually have higher capital costs but reduced operational costs.

Respondent A claimed that "historically the perception from the public sector has been that they are paying over-inflated costs for both the build and FM services. A balance needs to be struck between the two parties so true Value for Money can be delivered." By this, he meant that the projects need to give the contractor an opportunity through the successful delivery of the works (as a D&B Contractor) and the longevity of managing the facility (if in-house), whilst also the public sector needs to feel they are receiving a high quality facility from the D&B contractor and VfM from the FM provider. All three respondents were aware of the rationale for calculating VfM in regards to the public sector comparator. Respondent C claimed that this was a big risk for contractors as although they have control over the price for the works, if the public sector cannot stack up the costs and justify VfM the project may be cancelled.

#### Question 2

What improvements could be made to the PFI process to drive out best VfM procured project?



### **Responses to Question 2**

The respondents believed that standardisation of documentation and output specifications, a more balanced risk sharing, reduced tender period and cost, were key to improving VfM. Respondent B emphasised the importance of the integrated approach between the design and build (D&B) contractor, FM provider and owner operator as key to providing value for money. The incentive for each party to work together to increase profitability on the projects for the whole company is a key differentiator to other traditional projects where these entities are usually kept separate.

Respondent C explained that on a traditional D&B contract, the contractor only has responsibilities for meeting the design and specifications. Once construction and defects are complete, they will hand over the job with the relevant warranties in place, whereas on PFI there is far more responsibility in respect of whole life cycle costs.

Respondent A claims that real value comes from the D&B contractor having more scope to innovate claiming that "most real innovation comes from the bottom up". Therefore, having the D&B contractor involved and in many cases responsible for the design from an earlier stage compared to traditional contracts, gives the best opportunity for innovation and better value for money.

### **Question 3**

What value do main contractors bring to PFI projects that the public sector would not be able to offer in a traditionally procured project?

### **Responses to Question 3**

The respondents were in agreement that contractors brought their experience and expertise to bear in PFI to enhance VfM. Key areas of contractors' contribution are in innovation, design management and risk management as well providing finance. Respondent C explained that on a traditional design and build contract, the contractor only has responsibilities for meeting the design and specifications. Once construction and defects are complete, they will hand over the job with the relevant warranties in place, whereas on PFI there is far more responsibility in regards to the whole life cycle of the projects. Respondent A claimed that real value comes from the D&B contractor having more scope to innovate claiming that "most real innovation comes from the bottom up". Therefore, having the D&B contractor involved and in many cases responsible for the design from an earlier stage compared to traditional contracts, gives the best opportunity for innovation and better value for money.

An interesting point made by Respondent A was that contractors, through delivery and management of PFI projects, are able to offer the public sector the financial stability of delivering a continuous service due to their strong financial backing. But for this stability and finance, these complex and expensive public sector projects would not go ahead at all.

### **Question 4**

What particular risks do contractors bear on PFI projects that they would not normally take on in other forms of contract?

#### **Responses to Question 4**

The respondents stated that contractors bear high risk levels due to high collateral warranties, high damages for non-performance, unrecoverable bid costs, unavailability charges and whole life cycle responsibilities inherent in PFI contracts. Respondents A and B commented that a key risk taken on by contractors on PFI schemes, is that of unavailability charges. This is where the client can reduce the unitary payment due to the consortium or contractor if a facility or part of a facility becomes unusable due to heating failure, for example. Respondent C stated that "Due to the increased risk profile placed on the contractor, the contractor looks to offset this risk with higher costs which are delivered back to the public sector; working in greater collaboration from the commencement of a project, where risk is understood and quantified, will provide better value for money for all parties".

#### **Question 5**

Do the risks contractors take on justify the allegedly high returns reported in the media?

#### **Responses to Question 5**

All the respondents agreed that due to the high risk profile of PFI projects, they deserve high returns. They alluded to the fact that if a contractor can manage the risks and deliver the project to a good standard then they should be rewarded. The consequences of not delivering to time, budget and a good standard can be quite severe and can mean major losses. Respondent A stated that the fact that contractors normally take on full project risk justified this position, adding that 'much of the criticisms are in regards to re-financing costs and the lack of transparency. If the private sector is taking on all of the risks on a project and they aren't shared fairly, should they be expected to share profits on re-financing?'

Respondent B claimed that estimating the extended product design lives and lifecycle costs were fraught with danger in that any errors or miscalculations could lead to further costs down the line. Respondent C agreed that although some of the returns reported are high and may amount to "profiteering", contractors bear a great deal of risk and need to balance their positions or it would be unviable to tender for the works. The works are competitively tendered and more should be done at this earlier stage to understand the risks on the project, quantify them with the contractors and in turn provide better value for all parties involved.

#### **Question 6**

The Private sector has been accused of profiteering on PFI projects. What is your opinion on this and what have been the major issues that affect profitability for contractors on PFI schemes in your experience?

#### **Responses to Question 6**

The respondents pointed out that profit levels were different for main contractors and FM providers, and that most of the criticisms relating to contractors' profits are borne more out of myths and exaggeration than of reality. They suggested that client education was required to help clients understand the FM contracts where the issues of profiteering are more critical.

Respondent C strongly disagreed with the profiteering allegation, stating that PFI projects have been "bitter experiences" for many major contractors in recent times. The risk profile has caught many contractors out on issues such as ground



conditions or asbestos surveys for example where the contractor takes full risk for these aspects of a project without knowing too much about them. Respondent A felt that the issue with profiteering, particularly on school projects, sat more with the FM companies who charged high sums for simple items such as replacing a chair. He urged clients to be more educated in regards to the deals and understand the rationale before signing up to them and moving forwards on projects. Respondent B again highlighted the fact that without PFI, the major public spending would not have happened, adding that if contractors delivered schemes well, then there were significant profits to be made. In the same vein, however, as the schemes were difficult to get right and cost a significant amount to tender, projects could easily go wrong and lead to a loss to the contractor.

## CONCLUSION

This study has explored contractors' views on value for money in PFI projects in the UK. The interview results showed that the contractors have a clear understanding of what constitutes VfM in PFI projects. They believed that an integrated approach offered the best incentives for all parties to achieve VfM. The respondents stated that contractor deployed their expertise and resources to foster innovation in PFI projects, especially where they played a key role in project design. The results also suggest that a more balanced allocation of risk between public and private sector parties is required for optimum VfM. According to the respondents, the allegations of profiteering by contractors were in most cases more fiction than fact; there were also cases of contractor suffering losses as a result of the complexities of PFI projects. It is expected this study will encourage more investigations to get the contractors' side of the story in the PFI debate. This could help reform the concept and practice of PFI in the UK to engender public confidence in this rather controversial procurement system.

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