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Private Opportunity, Public Benefit?

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Abstract

The newly elected Labour government has pledged to 'reinvigorate the Private Finance Initiative', as part of the new emphasis on 'public/private partnerships' in the delivery of core public services. This article assesses the merits of using private finance to deliver public services against three criteria: whether it will lead to additional investment in social infrastructure, whether it represents good value for the taxpayer's money and whether the use of private finance will reduce the public sector's flexibility to pursue its public service objectives.

JEL classification: H54, H11.

I. INTRODUCTION

In recent years, governments world-wide have sought to increase the involvement of the private sector in the delivery of public services. These initiatives have taken many forms such as outright privatisation of previously state-owned industries, contracting out of services such as refuse collection or cleaning to private firms, and the use of private finance in the provision of social infrastructure. Privatisation has occurred in over 100 countries, most notably in the former Communist countries of central and eastern Europe. Contracting out of labour-intensive services has also been widespread.[1] Concessions to build and operate large-scale infrastructure networks such as roads have been of particular

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[1]Refuse collection, for example, has been contracted out in the US and Canada amongst others (McDavid, 1985).

interest to rapidly developing countries in South America and South-East Asia (Desai and Brooks, 1997).

Within the UK, interest in introducing 'private capital and expertise in to the provision of public infrastructure'[2] appears to have survived last year's general election, with the Labour Party's election manifesto pledging to 'reinvigorate the Private Finance Initiative' (PFI). Once in office, the government-commissioned Bates Review recommended 29 legislative and procedural changes intended 'to identify any obstacles in the way of bringing PFI projects to fruition'.[3] More recently, the terms of reference for the Comprehensive Spending Review called for departments to examine the scope for greater use of public–private partnerships in the delivery of public services. This paper provides a preliminary assessment of the effects on social welfare of using private finance in the delivery of public services on the basis of three criteria:

- *Additionality*. Does the PFI allow the creation of additional social infrastructure?
- *Value for money*. Does the PFI provide value for money?
- *Public objectives*. Does the use of private finance reduce the public sector's flexibility to pursue its public service objectives?

Section II traces the development of the Private Finance Initiative in the UK. Section III considers whether the PFI is likely to result in the provision of more social infrastructure than would have gone ahead under traditional procurement routes. Section IV looks at the arguments and initial evidence on whether the PFI is likely to prove good value for taxpayers' money. Section V assesses the impact of using private finance on the public sector's ability to deliver its public service objectives. Section VI concludes.

II. THE DEVELOPMENT OF THE PRIVATE FINANCE INITIATIVE

The launch of the PFI in the UK marks a dramatic shift from the general presumption against the use of private finance in social infrastructure projects which had previously existed in the UK. This presumption against private finance was embodied in the Treasury's Ryrie rules which operated during the 1980s. These rules insisted that privately financed projects could only proceed if they offered better value for money than a hypothetical public sector 'comparator', even if budget constraints meant that the public sector alternative would not go ahead. As Willetts (1993) argued, 'the notorious Ryrie rules were a tease — the conditions they set for privately financed projects were never likely to be met in practice'.

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[2]HM Treasury, 1997.
[3]HM Treasury Press Release 69/97.

The Ryrie rules were relaxed in two stages (in 1989 and 1992) so that a public sector comparator would no longer be required if either the project could be financed through user charges or there was no reasonable possibility of the project going ahead within the public sector (Heald and Geaughan, 1995; HM Treasury, 1992).[4] HM Treasury (1993) distinguished three types of PFI project:

- *Financially free-standing projects* where the outlay can be recouped through user charges such as the Skye Bridge.
- *Joint ventures* where the public sector provides the PFI contractor with a subsidy to reflect the social benefits of a project not reflected in cash flow, such as the Docklands Light Railway extension to Lewisham, the Manchester Metrolink and the Channel Tunnel Rail Link.
- *Services sold to the public sector* such as those provided by Bridgend Prison, Design, Build, Finance and Operate (DBFO) road schemes and new trains for London Underground's Northern Line.

Under traditional procurement practices, the construction of publicly owned assets such as roads or prisons is typically undertaken to detailed specifications by private contractors following a competitive tender. Once completed, the public sector is responsible for providing public services using publicly owned infrastructure. Under PFI service contracts, the public sector purchases services such as the availability of prison places or office accommodation from the private sector which owns and manages the underlying infrastructure. This affects how public services are financed and delivered but not who ultimately pays for them. Instead of capital spending having a one-off impact on the public accounts when the investment occurs, there is a stream of future revenue commitments over the lifetime of the service contract, pushing the date at which capital investment scores against public spending totals and the public sector borrowing requirement (PSBR) into the future. Even when a private contractor recoups its costs via user charges, such as with the Skye Bridge or the Second Severn Crossing, this represents income that would otherwise have accrued to the state.

Despite some concern over delays in the process of tendering and signing PFI contracts (Treasury Select Committee, 1996), deals with a capital value of over £7.5 billion had been signed by November 1997.[5] Whilst the fact that PFI deals are actually going ahead is welcome evidence that the initial hurdles involved in getting the PFI off the ground are being overcome, the value of contracts signed

[4]In 1989, the requirement of public sector comparators was dropped when 'the private sector takes full responsibility for the success or failure of a project'. In 1992, the need for a comparator was dropped 'if the private sector is wholly responsible for a project which needs government approval and can recoup all of its costs by charges at the point of use' or where public finance would not be considered affordable 'in the foreseeable future'. See Dilnot and Giles (1995) for a fuller discussion.

[5]Source: HM Treasury, 1997.

is at best a partial measure of policy success. In the following sections, we present a broader assessment of the merits of the PFI based on whether desirable projects would not have gone ahead in the absence of the PFI and whether the use of private finance represents value for money for the taxpayer or a suitable basis for realising public service objectives.

III. HAS THE PFI LED TO ADDITIONAL INVESTMENT IN SOCIAL INFRASTRUCTURE?

During the early stages of developing the PFI, the Treasury implied that the PFI would allow additional investment in social infrastructure compared with what would be possible using conventional public finance alone. The November 1994 Financial Statement and Budget Report stated that the 'private sector's contribution is additional to public provision. This means that, for a given amount of public expenditure, new and better quality capital investment will be secured by the nation'. For the use of private finance to allow *desirable additional* investment in social infrastructure implies that there is some artificial constraint on public sector borrowing which would otherwise prevent investment in social infrastructure with positive net benefits from proceeding. This appears to depend on an argument that the public investment programme is constrained because it scores against the current year's PSBR, used by many commentators as an indicator of the government's fiscal competence, whilst PFI spending is not constrained in the same way because it involves a string of (perhaps uncertain) commitments which will affect the PSBR at some stage in the future. In such a case, additional investment might enhance social welfare, whether or not private finance were more efficient.

Of course, if the public and private sectors are equally efficient, the present discounted value of the government's liabilities should be the same under traditional procurement and under the PFI. Therefore, if the PSBR is seen as a useful measure of the government's impact on the macroeconomy, then attempts to get around the precise definition of the PSBR will simply distort its usefulness as a measure or lead to the measure being redefined to include all 'government-sponsored capital investment'. In any case, central government departments plan to produce budgets using resource accounting methods by April 1999 (HM Treasury, 1995a). Rather than public sector investment scoring against public spending totals in the year the investment occurs, it will be depreciated over the lifetime of the asset in a similar fashion to PFI spending, reducing any incentives for public sector managers to choose PFI rather than traditional procurement for reasons other than value for money.

Since the use of private finance pushes forward the time when capital investment scores against public expenditure, there is a danger that public sector managers used to the traditional three-year public expenditure planning horizon

TABLE 1

Forecast Publicly Sponsored Capital Expenditure for 1997–98

£ billion

	Nov. 1994	*Nov. 1995*	*Nov. 1996*	*March 1998*
Public sector investment	21.8	19.8	18.0	17.0
PFI investment	***	2.6	2.5	1.5
Publicly sponsored investment	21.8	22.4	20.5	18.5

might pay insufficient attention to the growth of contractual commitments in the future.[6] The Treasury decision to publish information on such future commitments alongside the Budget documentation is to be welcomed in this respect. In practice, however, the planned expansion of the PFI in recent years has been accompanied, in successive Budgets, by cuts to the public sector capital programme, suggesting that private finance has been used as a *substitute* for rather than as an *addition* to public sector investment.

Table 1 shows that, since the November 1994 Budget, public sector investment plans for 1997–98 have been cut three times — by £2 billion in November 1995 (representing a 9 per cent cut), £1.8 billion in November 1996 (9 per cent) and £1 billion in March 1998 (5.5 per cent).[7] In the November 1995 Budget, planned spending of £2.6 billion under the PFI more than compensated for reductions in public sector investment, leaving total publicly sponsored investment £0.6 billion higher overall. However, subsequent reductions in public sector investment plans, combined with delays in taking PFI projects forward, have resulted in an estimated out-turn for total publicly sponsored investment in 1997–98 that is some £3.3 billion lower than originally planned within the public sector alone. Forecasts of publicly sponsored investment for 1996–97 and 1998–99 have evolved in a similar manner.

Far from generating additional investment, this evidence might be taken to suggest that PFI spending has not even compensated for cuts to public spending plans. We cannot draw any definite inferences from such evidence since we cannot determine whether public sector capital investment plans would have been cut even in the absence of the PFI. Since it is often politically more expedient to delay capital projects than to rein in current spending in times of fiscal restraint, capital budgets have traditionally been targeted (Sentance, Hall and O'Sullivan, 1998).

[6]See, for example, Treasury Select Committee (1996).

[7]The out-turn GDP deflator for 1997–98 was forecast to be 2.75 per cent in the March 1998 Budget compared with forecasts of 2.5 per cent in the 1994 and 1995 Budgets and 2 per cent in the 1996 Budget. The cuts in cash plans between Budgets therefore represent substantial real-terms cuts.

Even if the existence of the PFI had driven the cuts to public budgets in recent years, this is compatible with a strategy of overcoming institutional inertia by placing more pressure on public sector managers to give serious consideration to the use of private finance. This does not necessarily mean that PFI spending will not be 'additional' in the longer run since such incentives may no longer be required once the initiative has developed.

In other cases, the observed shortfall between forecast and realised levels of PFI expenditure to date may reflect one-off delays associated with developing a new method of public procurement or the need for legislative reform.[8] The third PFI prison contract was let six months after the invitation to tender was issued, roughly 65 per cent more quickly than the first two deals (National Audit Office, 1997c). In health-care and local authority services, legislative clarification of the powers of NHS Trusts and local authorities to enter into PFI contracts was required. This might mean that concerns over delays to investment as a result of using the PFI may soon be of mainly historical interest.

IV. DOES THE PFI REPRESENT GOOD VALUE FOR MONEY?

This section considers whether the use of private finance is likely to provide value for money in the delivery of public services. One reason for expecting public finance to provide better value is that governments, as large-scale low-risk borrowers, can usually borrow money more cheaply than private sector bodies. Of course, the government borrowing rate does not reflect the risks of individual projects whereas private borrowing rates may do, and it would be wrong to discriminate against private financing because it made explicit costs that, with public financing, are hidden but no less real. However, it is reasonable to expect that costs of uncertainty around the expected return from the project will be greater when they are concentrated on the providers of private finance. The loan stock for the Skye Bridge had a 2 per cent risk margin over comparable gilts.[9] The use of the PFI will incur additional financing costs due to the need for some element of equity finance. The projected real rates of return on equity invested in the Fazakerley and Bridgend prison contracts were 12.8 per cent and 19.4 per cent respectively. Whilst the use of private finance on the Skye Bridge led to £4 million additional financing costs compared with the 6 per cent real cost of capital used by the public sector, 73 per cent of this represents the return to the providers of equity capital.[10]

Value for money in PFI schemes depends on any gains in efficiency through private sector involvement more than compensating for higher finance costs

[8]The National Audit Office (1997b) found that using the PFI route delayed progress on the contract for a replacement National Insurance recording system (NIRS2) by six months.
[9]The real rate of return in gilts at the contract date was 4.5 per cent.
[10]National Audit Office (1997a) estimate based on central forecasts of traffic, inflation and interest rates.

(Heald, 1997). It is difficult to obtain clear evidence on this, since many PFI projects are large-scale one-off projects for which it is very difficult to calculate an *accurate* and *uncontroversial* public sector comparator. Given the paucity of reliable empirical evidence available at present, we examine three arguments that have been advanced to suggest that the use of private finance can indeed represent value for money. First, the private sector might be inherently more efficient or more innovative than the public sector. Second, private finance might extend competitive pressures to more of the processes involved in the delivery of public services. Third, the private sector may be able to manage some types of risks more effectively than the public sector. We examine each of these arguments in turn.

1. Public versus Private Provision

Whilst capital market disciplines and different managerial incentive structures are often claimed to make the private sector inherently more efficient than the public sector, there is little empirical evidence to support this view (Kay, 1993) since there are relatively few examples of public and private firms competing against each other in the same markets and under the same competitive pressures. Recent experience in contracting out refuse collection services in the UK did, however, suggest that public sector organisations winning contracts achieved less than half the cost reductions made by private firms (Szymanski, 1996).

Public sector managers may not face incentives to take risks through innovation (Dixit, 1997). This is one reason why third-party income (revenue from users of the asset in addition to the government) may be an important source of value for money on PFI contracts where spare capacity is created. The provision of computer systems for the National Insurance system (NIRS2) was found by a recent National Audit Office report (1997a) to represent 'strikingly good value provided the service contracted for is delivered'. The contractor, who retained intellectual property rights to the system, made a final bid well below the level of its original bid since it hoped to spread the substantial fixed costs of the project by making further sales to other organisations. The generation of additional receipts through more intensive exploitation of assets in this way may allow lower costs for other public sector programmes such as school sports facilities.

2. The Role of Competition

Even if private firms are not inherently more efficient than public sector organisations, PFI could bring efficiency gains by exposing more of the stages involved in the delivery of public services to the process of competition. Under traditional public procurement, private sector firms competed in how to deliver detailed project specifications at lowest cost. Under the PFI, private firms

compete to provide specified services to the public sector, being left free to innovate in project design, the balance between construction and maintenance costs and the transfer of risks from the public sector. This is not the traditional notion of competition within the market, of course, since many public services have a significant monopoly component, but rather a process of competition for the market (Chadwick, 1859). Baumol, Bailey and Willig (1982) argue that the process of competition for a market could still deliver welfare gains for society as a whole, even if there were no process of competition within the market. Limited availability of data and non-homogeneous contracts have resulted in few empirical studies of this issue, other than for refuse collection.[11] Szymanski (1996) found that the introduction of compulsory competitive tendering (CCT) in refuse collection in the UK in the late 1980s had led to average savings in net spending of 18 per cent, even though 75 per cent of the contracts were awarded to public sector organisations. In each case, cost reductions appeared to be linked to changing the input mix and reducing wage costs towards market levels.

Value-for-money gains depend on the existence of a competitive bidding process. Gómez-Lobo and Szymanski (1997) found that a higher number of bids in the process of contracting out local authority refuse services was associated with a lower cost of service. The National Audit Office (1997b) has therefore expressed concern that some important financing costs in the Skye Bridge contract were determined through negotiation with the preferred bidder rather than through competition.

The number of consortia interested in large-scale PFI contracts is likely to be influenced by the likelihood of incurring significant bidding costs, varying from £0.5 million to £2.5 million in the NIRS2 contract, for example (National Audit Office, 1997b). The deterrent effect of these costs will be greater if there is any uncertainty over whether departments will take projects forward through the PFI, leading to the Bates Review recommendation for departments to 'road-test' projects for commercial viability before issuing formal invitations to tender. One feature of contract design that is likely to influence the number of potential bidders, as well as the amount of risk that private bidders are willing to bear, is the liquidity of their investment. The public sector needs to achieve an appropriate balance between allowing the transfer of equity stakes and the importance of having a clearly defined private sector partner. This is particularly important for public–private partnerships or where the public sector provides either upfront subsidy or assets such as land with development potential as part of the deal (HM Treasury, 1996a). Whilst too few bidders in large-scale capital projects may lead to insufficient competition, inviting too many firms to submit

[11]The main exceptions to this being oil drilling rights in the US and timber in the US and Canada. See Laffont (1997) for a survey.

formal bids may reduce effective competition due to the lower probability of each bidder winning the contract.

3. Risk Transfer

A central issue in PFI is a more efficient allocation of risk between the public and private sectors (HM Treasury, 1995b). This is not simply a question of how much risk is transferred but what types of risk are transferred, since the private sector will only be able to reduce the cost of risk if firms can either reduce the overall level of risk or manage those risks more effectively. This is explicitly recognised in the HM Prison Service study (1996) of the first two Design, Construct, Manage and Finance (DCMF) prison contracts, in which it was felt that 'the proposed allocation of risk to be transferred under the DCMF package maximises the chance that such risks *do not materialise*' (italics added).

The allocation of risks and incentives faced by the private sector in PFI projects is largely determined by the choice of payment mechanism under the PFI contract. Long-term service contracts based on service availability, such as the DCMF prison contracts or the DBFO road contracts, encourage private firms to minimise the 'lifetime costs' of projects by balancing higher construction costs against lower maintenance costs in the future. Payment mechanisms that are not triggered until a service is being supplied, such as the NIRS2 contract, provide strong incentives to avoid delays in design and construction, especially where the contract termination date is independent of when service delivery actually commences.[12] Similarly, payment mechanisms based on the availability of prison cells or Underground trains give incentives for adequate maintenance. The potential for efficiency gains may be considerable, especially where construction risks, which have sometimes led to large cost overruns under traditional public procurement, can be reduced or simply better managed by the private sector. HM Prison Service (1996) reports that out-turn costs averaged 18 per cent higher than tender price under traditional procurement.

In principle, the gains resulting from minimising 'lifetime costs' rather than construction costs could be realised within the public sector. Public sector managers faced with pressures to control annual departmental budgets may be tempted to economise on short-term construction costs, and construction companies may face few incentives to look for design or construction changes that would give long-term economies. The introduction of resource accounting will improve these incentives, at least for public sector managers, but only to the extent that it is annual resource costs rather than cash costs that limit their spending.

[12]Whilst the contractor has borne the risk of lost service charges as a result of delayed implementation, the Contributions Agency was not compensated for the loss of efficiency savings resulting from relying on the original National Insurance recording system for longer than anticipated.

The degree of price and cost indexation built into service contracts will be more important to the overall allocation of risk in contracts where complementary inputs are purchased alongside the core service. In the Skye Bridge contract, where complementary inputs are negligible, the real value of total payments is fixed, effectively transferring all cost risks to the private sector.[13] For prison contracts, by contrast, cleaning, catering and security services are packaged together with the core service of cell availability. In such cases, periodic pricing reviews or the specification of circumstances that can trigger price revisions, such as changes in costs outside the contractor's control, may need to be written into contracts. In the DCMF prison contracts, provisions allow both parties to demand a variation in the price of services if there is a change in the consortium's costs outside its control. Price variations should always be related to published price indices which reflect input costs but are outside the control of the contractor concerned.

Whilst a more efficient allocation of risk between the public and private sectors carries considerable scope for improving value for money in public service provision, the precise allocation of risk is a complex and difficult process. Poor value for money is likely to result from the transfer of either *too little* risk to the private sector (which may dull efficiency incentives) or *too much* risk or the wrong types of risk, leading to higher costs. The latter may occur where the private sector is asked to bear risks that it cannot control, such as *volume risk* and some types of *residual value risk*. There is also a question of whether transfers of risk to the private sector will turn out to be more apparent than real. We consider each of these issues below.

(a) Volume Risk

Transferring risks associated with public policy decisions, such as the public sector's demand for a service, over which a private contractor has little control, is more akin to the public sector purchasing an insurance contract. This is unlikely to be a cost-effective strategy. There should be cause for concern where the principal payment mechanism under PFI contracts is related to volume of usage rather than availability of a service, since the former is largely outside the control of the private operator.

PFI deals signed to date have experimented with alternative allocations of volume risk. In the tenders for the first two DCMF prison contracts, private firms were unwilling to accept volume risks associated with sentencing policies, which were seen as outside their control. In the Skye Bridge contract, which is similar to the Least Present Value Auctions proposed by Engel, Fischer and Galetovic (1997), the contract length is variable, ending when a predetermined volume of toll revenue has been collected. By contrast, the first eight DBFO road contracts

[13]One risk that could obviously not be transferred to the private sector was the policy risk that the government would succumb to local political pressures and subsidise bridge tolls.

involve the use of 'shadow tolls' where payments depend on the volume of traffic (subject to a volume 'cap') but are paid by the government, not by service users. Unlike lane closures resulting from poor maintenance, risks arising from traffic volumes are largely outside the control of road operators and hence risk transfer is unlikely to lead to value for money. The National Audit Office (1998) recently concluded that the 'use of shadow tolls as the primary means of payments to operators may have reduced the net savings generated by the contracts'.

Payment mechanisms based on traffic volumes raise two additional sets of dangers. First, the winning bid comes from the consortium with the most optimistic forecast of general traffic growth, not the most efficient. Such a 'winner's curse' may generate considerable pressure for the government to extend the length of the original concession, effectively returning the demand risk to the public sector. Second, tender prices may be highly sensitive to policy decisions by the public sector over the availability of competing services such as the withdrawal of the public sector Caledonian MacBrayne ferry service upon completion of the Skye Bridge and upgrades to roads competing with DBFO schemes. Whilst contracts that terminate once an agreed present value of tolls has been collected avoid some of these problems, consideration needs to be given to providing incentives to avoid delays in construction and ensure adequate maintenance.

(b) Residual Value Risk

The assets created under PFI deals typically have an expected useful life beyond the formal contract period.[14] Risks associated with how much the assets will be worth at the end of the service contract will have an important influence on the value of initial bids and the incentives facing contractors. The (now defunct) Private Finance Panel (1996) argued that 'there is no need for the public sector to concern itself with the residual value of an asset in a carefully structured PFI contract'. Whether such an approach is desirable depends on whether the residual value of an asset is largely subject to decisions taken by the contractor, as occurs when competitive markets already exist for the supply of assets, or may reasonably be expected to develop in the future. In office accommodation contracts (see HM Treasury (1996b)), for example, competitive markets already exist and private contractors can control some of the risks associated with residual value, such as maintaining the accommodation to a good standard.

Many PFI contracts involve highly specific assets for which competitive markets are unlikely to develop and where contract renewal will largely depend on decisions by public sector managers. This may lead private contractors, fearful of the residual value of assets being close to zero, to attempt to recover

[14]The major exception to this is Information Technology contracts which typically have both a shorter contract length and a requirement for a 'technology refresh' mid-contract.

their full costs over the service contract and yet retain ownership of the assets. Where contracts involve significant investments in relationship-specific capital, contracts that rely on repeated bargaining at a later date are likely to be unattractive (Joskow, 1987). This is a familiar issue in the literature on franchising in the presence of specific capital assets (Williamson, 1976). The general result is that this degree of uncertainty over the residual value of the asset at the end of a contract whose length is shorter than the expected useful life of the asset leads to private firms being less willing to invest in such capital assets or demanding a higher price for doing so.

In some PFI deals, such as the DCMF prison contracts, residual value risk has been largely retained by the public sector, which takes ownership of the prisons at the end of the formal service contract, with the assets maintained to pre-arranged quality standards.[15] This seems sensible since difficulties associated with obtaining planning permission for new prisons may render the supply of such assets relatively inelastic, even in the longer run. Private operators can be expected to recover the full value of their investment during the 30-year contract period.

PFI deals where ownership of the underlying assets remains in private hands at the end of the PFI service contract are of more concern. In the Northern Line trains contract, the expected train life of 36 years exceeds the initial service contract length of 20 years. Whilst such contracts may give private operators incentives for adequate maintenance in order to improve their prospects for extending the original contract, reversion to public ownership at a fixed quality standard would provide similar incentives. Indeed, a second auction for the operation of the trains after 20 years could plausibly yield lower costs than negotiation with a single asset-owner in a quasi-monopoly position *vis-à-vis* the public sector. The transfer of residual value risk may, however, be appropriate for Information Technology contracts, where the speed of technological progress makes contracting future quality standards very difficult and private management of system upgrades may have a significant bearing on contract renewal and hence residual value.

(c) Risk Transfer More Apparent than Real

Value for money in PFI deals will clearly be compromised if the public sector ends up bearing risks that have supposedly been transferred to the private sector. The National Audit Office study (1997c) of the Bridgend and Fazakerley prison contracts, recognising such concerns, recommended that future contracts should unambiguously reflect the department's understanding of how the risks are to be allocated between the signatories. Most of the risk transfer in PFI contracts

[15]To ensure this risk is transferred to the private sector in practice, it may be necessary for operators to post a 'maintenance bond' with the department which is released once transfer has occurred. This was built into the Skye Bridge contract, amongst others.

signed to date does, however, appear to have been real. PFI deals are contracts for the delivery of a public service at an agreed price, not for the supply of an asset. As a result, PFI service contracts typically specify payment mechanisms that are not triggered until service delivery commences, that are not responsive to realised construction or maintenance costs and that apply financial penalties for delivery failure. Payments in the first two prison contracts depend on the availability of both cells and complementary inputs such as staffing, food and health-care services. Controllable risks, such as non-availability of cells due to inmate damage, will also result in penalties (HM Prison Service, 1996). Similarly, payments to the contractor for the NIRS2 contract will not commence until the system is operating satisfactorily, and £3.1 million of the £3.8 million additional costs incurred through unforeseen delays are to be borne by the private sector (National Audit Office, 1997b).

Whilst a clear allocation of risk in PFI contracts should minimise such concerns, this may be imperilled if private operators get into financial difficulties.[16] In cases of default, the government can contract for 'step-in' rights to take over the service and can cap its liability. In the first two prison contracts, for example, the public sector's liability is the minimum of outstanding borrowings[17] or the net present value of the unexpired part of the service contract. Whilst the risks of default could be fully transferred to the private sector if adequate insurance were available, this is unlikely to be cost-effective. In the Bridgend and Fazakerley prison contracts, for example, the government agreed to act as 'insurer of last resort', effectively transferring the risk back to the public sector.

The greatest potential risks for the public sector may occur where a contractor goes bankrupt before the construction of the infrastructure is complete. This risk will typically be minimal unless the cost of rectifying the problem that caused default exceeds the value of the work undertaken. In cases where this is likely, it may be necessary to write contracts that include the posting of performance bonds that can be released once certain milestones in the construction process are passed, as in the DBFO road contracts. The problem is far more worrying where the government has already made a capital contribution as part of a public–private partnership, such as the Docklands Light Railway extension or Channel Tunnel Rail Link. Even if the government is willing to contemplate the bankruptcy of a high-profile project, it may be unable to recover the value of its original contribution, even though the level of compensation payable to the defaulting contractors may be zero. In addition, projects involving infrastructure required as part of a network will have to be re-tendered, effectively transferring

[16]In some cases, lenders have been given 'step-in' rights so that they can replace an operator without contract termination, thus reducing their risks and ensuring service continuity.

[17]Obviously, equity investors would not be compensated. Equity covered 2 per cent of the capital raised for the Skye Bridge, for example.

the realised construction risk back to the public sector. In practice, the government might be tempted to alleviate pressure on private consortia by agreeing to additional public contributions, as demanded by the contractors for the Channel Tunnel Rail Link, or to extending the term of the concession on the asset, as occurred in the case of the Channel Tunnel. Both of these represent hidden subsidies and should be borne in mind when assessing the efficiency of the PFI. Similar demands have arisen in many other countries (Engel, Fischer and Galetovic, 1997).

4. Initial Evidence

An accurate assessment of the cost savings that have been realised through the use of PFI deals is difficult, both because a public sector comparator was not made in many cases and because those that were used can be highly sensitive to the assumptions on which they are based. Indeed, the practice of cutting public sector spending *in anticipation* of PFI deals going ahead led to some criticism that the initial tranche of PFI contracts would represent 'best available value' (since public sector alternatives may not be available, even if better value) rather than 'best value' since public sector managers may have faced considerable pressure to go ahead with PFI projects as the only practical method of proceeding (Treasury Select Committee, 1996; Heald and Geaughan, 1997).

The initial evidence from the first tranche of DBFO road schemes suggests that, whilst significant cost savings have been achieved overall, estimated savings vary considerably between different projects and according to the assumptions on which the estimates are based. The Highways Agency case study (1997) of the contracts claimed total quantifiable financial savings of £168 million compared with previous public sector procurement, using the 8 per cent discount rate applied by the Treasury to publicly financed road and rail projects. When the National Audit Office (1998) used a 6 per cent discount rate, which gives more weighting to future payments, this saving was reduced to £100 million. In addition, the second study suggested two of the four projects would have provided better value for money under traditional procurement methods.

Whilst the two DCMF prison contracts at Bridgend and Fazakerley generated estimated total savings of 10 per cent compared with prisons that were publicly financed and had operations contracted out to the private sector, all of these savings came from Bridgend. Fazakerley cost roughly the same as the public sector comparator (National Audit Office, 1997c). By contrast, the NIRS2 contract cost an estimated 60 per cent less than an equivalent public sector development (HM Treasury, 1997).

It may well be that estimates of the cost savings achieved in the first batch of privately financed projects are not particularly informative as to the cost savings that can be achieved as the initiative develops, especially when departments have had objectives additional to simply achieving value for money from their first

few PFI contracts. The first tranche of road contracts were partially driven by the Highways Agency's interests in examining how PFI would work for different types of contract and in developing a competitive road-operating industry. In other cases, experiences gained in writing the first PFI contracts may lead to significant additional savings in future contracts. The Lowdham Grange prison contract was signed more quickly and at a lower cost than the first two prison contracts.[18] Estimates of cost savings on the basis of contracts already signed may not, of course, prove to be reliable indicators of whether these contracts turn out to be good value for money in the longer term.

V. IMPACT OF PRIVATE CONTRACTS ON PUBLIC OBJECTIVES

Whilst the initial evidence on value for money from the use of private finance provides some grounds for optimism, doubts exist over the welfare effects of allowing 'PFIability' to determine which projects go ahead and whether long-term contractual commitments will reduce the flexibility with which the public sector can respond to changing circumstances.

1. Project Mix

Ideally, to maximise social welfare, both the public sector overall and individual departments would prioritise projects according to a strict cost–benefit analysis of the relative merits of each competing demand on the public purse — those projects offering the highest expected social returns would go ahead. If private finance partially substitutes for public finance, however, the PFIability of projects may have a crucial influence on the composition of publicly sponsored investment. Heald (1997) reports that a public sector alternative to the Skye Bridge would not have gone ahead for at least 20 years. However, maximising social welfare would suggest that projects should be given the same priority, however they are financed. Otherwise, the bridge has replaced an alternative project, which presumably generated higher expected social returns when the public sector's priorities were drawn up.

The projects with the highest PFIability are typically those where the quantity and quality of outputs can be accurately measured (so real or shadow revenue streams can be used as a payment mechanism), that have the lowest element of risk and complexity and that are sufficiently large (or can be bundled together with similar projects). These characteristics are common amongst many transport projects, which might explain why these projects accounted for 71 per cent by value of the PFI contracts signed by October 1997.[19] These typically either produce marketable services that can be financed largely through user charges or

[18]The contract was 21 per cent cheaper than Bridgend and 36 per cent cheaper than Fazakerley.
[19]Source: HM Treasury, 1997.

have easily measurable outputs such as traffic volumes. Even for specific projects such as hospital developments, PFIability concerns may lead to a bias in favour of rebuilding over refurbishment. This raises a danger that projects may be given the go-ahead because of the practicality of the payment mechanism, and tolling schemes may be chosen even if other methods of finance would yield greater social or environmental benefits.[20]

It is probably too early to draw any long-run conclusions as to the impact of the PFI on the mix of projects commissioned by the public sector. If cuts to public budgets in the early years of the initiative were primarily used to put pressure on public sector managers to give serious consideration to the use of private finance, a temporary imbalance in the composition of the overall publicly sponsored capital programme is inevitable, with few longer-term consequences.

In some cases, the early bias towards transport projects may simply reflect short-run delays in other departments due to greater complexity, the testing of alternative models and the need for legislative reform. The Highways Agency chose the first four roads contracts to experiment with different types of scheme rather than to take forward its top-priority projects. Recent legislative reforms, such as the NHS (Capital Finance) Act and the Local Government (Contracts) Bill, which have clarified the powers of NHS trusts and local authorities, have helped to remove obstacles to many health and education projects. Once such initial delays are overcome, however, it would be regrettable if recourse to private finance resulted in PFIability considerations supplementing net social benefits as the principal criteria driving social investment decisions.

2. Impact on Public Sector Flexibility

PFI service contracts typically span 20 or 30 years to allow private contractors to recover their capital costs over a reasonable period, raising concerns that the public sector may end up contractually committed to paying for a service it no longer requires or can obtain more cheaply elsewhere. This inflexibility could result in a significant loss in operational efficiency. In practice, such dangers can be exaggerated, in so far as there is a resource cost to ceasing to use or under-utilising publicly owned assets, despite cash-based public accounting effectively treating the use of assets as having zero cost once constructed.

The cost to the public sector of terminating a PFI contract is likely to depend on how competitive the market for the service provided is. Contracts that share demand risk either continuously or through 'break clauses' at pre-specified dates may provide good value for money where private contractors can manage what is

[20]Heald (1997) quotes Department of Transport figures to suggest that the discounted benefits of an untolled public sector Birmingham Northern Relief Road would be considerably larger than the PFI tolled project that has gone ahead.

effectively a residual value risk at an uncertain future date by supplying the service to alternative customers. Contract flexibility has been built into the Longbenton DSS office accommodation contract via sharing demand risk in this way.

The costs to the public sector of terminating a contract, either because the service is no longer required or because a lower level of provision is desired, are likely to be considerably higher in the case of specific assets. In such cases, risk-averse contractors may be inclined to try to recover their costs before the date at which a break clause can be activated, rather than over the whole lifetime of the contract. Some PFI deals, such as the Bridgend and Fazakerley prison contracts, effectively allow the public sector to 'buy out' the private provider at certain pre-specified dates during the contract. After five years, the prison may step in and terminate the contract voluntarily by paying the consortium its outstanding debt plus fair market value for its equity. In any case, the public sector's maximum liability for a service it no longer requires is capped at the remaining value of the contract, which leaves open the possibility of renegotiations, especially over contractual commitments for complementary inputs. It is not obvious that this leaves the public sector with less flexibility than if it had obtained the assets through traditional public procurement.

At present, the risks associated with reducing the flexibility of the overall £300 billion public expenditure programme appear negligible, largely because of the relatively small scale of PFI activity that has happened to date. Estimated payments under PFI contracts in 1998–99 total £1.03 billion, representing only 0.3 per cent of general government expenditure (HM Treasury, 1998). On the basis of PFI contracts signed to date, annual commitments will peak at about £3 billion around the year 2010. Obviously, the potential dangers of reduced flexibility will be greater for departments such as Transport where the most substantial PFI commitments exist, representing over 8.5 per cent of the department's annual budget by 2000–01.[21]

VI. CONCLUSION

I have assessed the Private Finance Initiative against three criteria — whether it will release resources for *additional* investment in social infrastructure, whether it will provide *value for money* for the taxpayer and whether the use of private finance will reduce the *public sector's flexibility* to pursue its public service objectives.

[21]John Watts, Minister of State, in evidence to the Treasury Select Committee, 11 July 1996.

The PFI has been accompanied by more-than-offsetting cuts in publicly financed investment. It is likely that these cuts were partly to put pressures on departments to examine PFI options and establish a new PFI culture. They also partly reflect the delays sometimes imposed by the development of new procedures. It is also possible that the cuts in publicly financed investment would have been substantial even in the absence of the PFI. However, it appears that, so far, the PFI has been a *substitute* for rather than a complement to publicly financed investment.

Assessments of *value for money* from individual PFI projects are highly sensitive to the assumptions made about the cost of the public sector comparator. The evidence suggests that the out-turns have been variable but that some PFI contracts have delivered good value.

The effects of the PFI on the *public sector's flexibility* to pursue its social objectives have yet to be established. The PFI tends to distort priorities in favour of PFIable projects, and can discourage activities that would prejudice the commercial interests of the PFI sponsor. On the other hand, the PFI may help the development of competitive markets which should enhance flexibility.

The gains realised through the PFI may increase with time as public sector managers gain experience in how risks and responsibilities can be optimally shared between the public and private sectors in a cost-effective manner. Competitive markets in the provision of many public services may also develop, significantly reducing the residual value risk associated with some PFI contracts, and reforms to overcome initial problems in sectors such as the NHS and local authorities may lead to a better-balanced mix of projects.

Overall, the initial empirical evidence that has emerged suggests that the PFI has the potential to increase the efficiency with which public services are delivered in the UK but that it cannot be taken for granted that private finance will represent good value for taxpayers' money in every type of capital project.

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