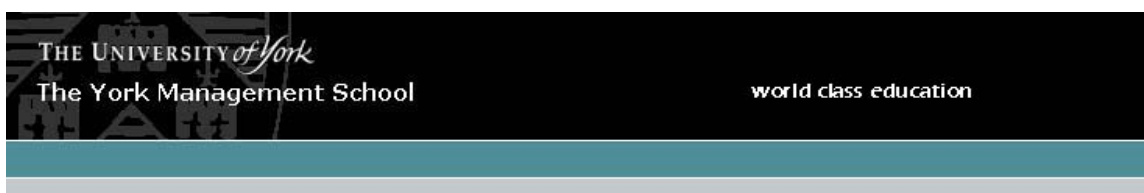


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THE PRIVATE FINANCE INITIATIVE (PFI) AND FINANCE CAPITAL:
A NOTE ON GAPS IN THE “ACCOUNTABILITY” DEBATE

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**This paper is circulated for discussion purposes only and its contents should be
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Abstract

During recent years, a wide spectrum of research has questioned whether public services/infrastructure procurement through private finance, as exemplified by the UK Private Finance Initiative (PFI), meets minimum standard of democratic accountability. While broadly agreeing with some of these arguments, this paper suggests that this debate is flawed on two grounds. Firstly, PFI is not about effective procurement, or even about a pragmatic choice of procurement mechanisms which can potentially compromise public involvement and input; rather it is about a process where the state creates new profit opportunities at a time when the international financial system is increasingly lacking in safe investment opportunities. Secondly, because of its primary function as investment opportunity, PFI, by its very nature, prioritises the risk-return criteria of private finance over the needs of the public sector client and its stakeholders. Using two case studies of recent PFI projects, the paper illustrates some of the mechanisms through which finance capital exercises control over the PFI procurement process. The paper concludes that recent proposals aimed at “reforming” or “democratising” PFI fail to recognise the objective constraints which this type of state-finance capital nexus imposes on political process.

Key words: accountability, private investment, public private partnerships, private finance initiative, finance capital, financial services providers, public sector management, public services, public sector employees, hegemony.

Introduction

Over the past 20 years, there has been a global trend towards the private sector financing of infrastructure projects (Merna and Njiru, 1998). This process has been particularly pronounced in the UK, where by 2004 the Private Finance Initiative (PFI) accounted for as much as 13.5% of total public investment (HM Treasury, 2003). Although PFI originated during the Conservative rule, it only became prominent during New Labour's administration which, since its election in 1997, consistently emphasised its commitment to PFI based procurement (DETR, 1998; HM Treasury, 1999; HM Treasury, 2003). New Labour's commitment to PFI has entailed a broad acceptance of the central role played by financial institutions in the procurement of public facilities. Accordingly, a recent Treasury publication notes that:

Typically, third party credit providers are more risk-averse than equity providers and provide the majority of the funding. The PFI approach and process thus leads banks and other financial institutions who lend to PFI projects to play an important role in ensuring that proper due diligence is performed, all important risks are identified and properly addressed and allocated to appropriate parties. They will seek to have robust and rigorous contractual undertakings from private

sector participants in PFI schemes and this is one of the reasons the PFI process delivers projects on time and to budget.

(HM Treasury, 2003, p. 40)

This emphasis on the use of private finance has been paralleled by largely unrelated government agendas which have sought to encourage accountability in the public sector. Paradoxically, the accountability dimension of PFI procurement has, until recently, been peripheral to the mainstream of PFI research. This can be attributed, in part, to the UK debate on PFI being highly politicised (Harding *et al.*, 2000) with supporters emphasising that private capital was making available infrastructure and services which would have otherwise not have been affordable (Debande, 2002; Stone, 2001) and critics stressing the “faulty economics” of PFI (Broadbent *et al.*, 2003; Froud and Shaoul, 2001; Ruane, 2000) and its negative impact on the quality of service delivery (Dunnigan and Pollock, 2003; Mayston, 1999; Glaister, 1999).

This paper focuses on what could be called second-generation objections to PFI which centre primarily on the governance and accountability implications of this form of procurement. Second-generation accountability criticisms have tended to approach PFI from several perspectives, which emphasise, *inter alia*, the problems associated with the complexity of PFI transactions, the monetarisation of public services provision and its long-term impact on the state as service provider. Focusing on the complexity of the financial arrangements underpinning PFI, a recent study sponsored by the UK trade union UNISON and written by Paul Gosling (2004) noted that:

The character of PFI schemes hides their reality from public gaze. Despite the use of public money, there is a veil of secrecy and a failure of accountability cloaking PFI and PPP contracts. This has been repeatedly commented upon the House of Commons' Select committees and others. This makes it extremely urgent to determine whether Value For Money has been achieved ...

In addition to the opacity of the original PFI and PP contract, we now have the additional obstacle to transparency and accountability of the secondary market. Investors are not only operating outside the limelight of publicity, they also see no reason why the public should be informed.

(Gosling, 2004, p. 11)

While the financial complexity of the PFI procurement process can hamper democratic oversight, the critics of PFI have typically failed to demonstrate that pre-PFI procurement in the UK was markedly more open. Perhaps more compelling, therefore, are critiques of PFI which focus its far-reaching impact on the state-market relationship in public service provision.

Investigating the impact of the contractual commitments typical of PFI contracts on the ability of the public sector to deliver services, Froud (2003) has argued that PFI procurement is not compatible with traditional assumptions about the appropriate role of the public sector. Rather than exploring the issues of accountability in PFI directly, Froud has centred her analysis on the question as to how the contractual management of

risks in PFI projects impacts on the ability of the state to respond flexibly to the needs of the public. In this context, Froud argues that the contractual treatment of risk in PFI undermines the traditional role of the government as risk bearer of last resort:

Under PFI, risk is seen as the chance of incurring increased costs and is managed by the application of an approach based on inter-firm contract relations such that, in principle, risks are distributed to those best able to bear them. ... There is little explicit recognition in this that government as a contracting party has particular characteristics that make it different from firms or individuals in terms of responsibilities, interests and modes of operation. Indeed, much of the current discussion of risk management in relation to PFI and in the UK Treasury's *Orange Book* more broadly focuses on risk management as a project or unit level activity, in the same way that a private corporation might consider the issue. This has practical appeal, as it is clearly simpler to employ a technicist approach to consider the risks from and to a particular public sector business unit or project, than to evaluate the issue of risk and uncertainty at the level of a public service. But it denies the traditional nature of government in taking responsibility for planning, organising and monitoring public service provision and responding to internal and external change.

(Froud, 2003, p. 585)

Froud's analysis complicates the issues of PFI as accountability-limiting procurement approach. Implicitly Froud proposes that PFIs are not lacking in accountability because criteria such as Value For Money (VFM) are too ambiguous to protect stakeholders, but

rather because the rigid contractual framework, which underpins PFI schemes and ensures their attractiveness to private capital, will make it difficult for the state to meet its role as service provider of last resort.

Relying on a structurally more rigorous analysis of the post-modern capitalist state, Kerr (1998) has been able to convincingly argue that the rhetoric of PFI on improving efficiency and public services has come to mask the active depoliticisation of state-sponsored service provision and its subjugation to the rule of money. According to Kerr this depoliticisation is part of an effort of the state to disengage from investment while stimulating capital accumulation:

In this way, the PFI marks a fundamental transformation of traditional public sector procurement methods, one in which the traditional and clear distinction between public and private activities and spaces is becoming obscured. ... This means that the public sector is now forced to think more objectively about the services it requires and also has to develop techniques to evaluate the complex private sector bids which have to be shown to provide Value For Money and transfer of risk. The private sector also had to come to grips with new organisational forms and methods of appraisal. ... In this way then, the PFI is attempting to transform the “public” service provision labour process in, at least two ways. Firstly, through the requirement to define and monetarise risk and to quantify future life-cycle costs and future service needs, the PFI is attempting to force greater objectification and “marketisation” into the provision of “public” services. Secondly, through displacing the service provision labour process from

the public to the private sector, the PFI is attempting to subordinate that labour process more effectively to the rule of money.

(Kerr, 1998, p. 19)

Kerr's suggestion that PFI acts as an instrument for the objectification of services and the marketisation of labour has concrete accountability implications. If PFI forces the public and private sectors to apply market-based approaches to decisions on service provision, then PFI is likely to foster processes which have the potential of undermining socially conscious labour practices which have evolved in the public sector. This in turn can lead to a situation where public expectations of fairness and social justice are no longer met.

While the de-flexibilisation and marketisation arguments of Froud and Kerr serve to highlight the adverse effect of this type of private capital involvement on domestic governance, they largely fail to recognise the fundamentally finance capital-driven anti-democratic agenda which underpins the PFI process. PFI, at its root, is neither about eroding the distinction between public and private, nor is it about the state shunting traditional responsibilities in an effort to alter its overall political economy. PFI is perhaps best defined as a deliberate strategic process in which the state creates new profit opportunities for finance capital, irrespective of the negative effects which the creation of these profit opportunities will have on other stakeholders, including consumers of public services and public sector employees. If de-flexibilisation and marketisation are amongst the outcomes of PFI, then this is a by-product of a much broader economic agenda, but not the *raison d'etre* for the adoption of this agenda itself; after all if de-flexibilisation

and marketisation were of primary political importance, they could be fostered by the state more effectively, without the initial direct involvement of private capital, via legislative intervention, such as mandatory contracting out requirements and/or the privatisation of a broad range of public services.

Linked to the profit-opportunity generating nature of PFI are certain processual characteristics of PFI, chief amongst which is the dominance of finance-sector driven risk-return criteria. Thus, it can be demonstrated that on the micro-level of processual decision-making, financial service providers exercise significant influence on the financial structure of PFI transactions, the risk allocation between PFI partners and other operational parameters. In other words, rather than lacking accountability on account of an inadequate involvement of stakeholders or on account of a reduced role of the state authorities in decision making, PFI systematically undermines accountable decision-making by subjecting key investment and procurement decisions to the risk-return criteria by financiers.

The following section of this paper expands and elaborates on this basic argument. It briefly maps out the contemporary role of PFI as a profit-opportunity generating mechanism. Section two elaborates on the implications of finance capital involvement on institutional decision-making and discusses some of the key PFI risks which typically enter the risk-return calculations of financiers. Sections three and four each present a case study of a recent PFI project with a special focus on the hidden deal-shaping role of

financial institutions¹. Section five concludes by highlighting the inherent contradictions which arise from the desire to deliver “modern” public services while creating new profit opportunities for private finance.

PFI as Profit Opportunity

In one of her last works Susan Strange (1998a) argued that financial arrangements, such as PFI, cannot be understood without broader comprehension of global finance. Specifically, Susan Strange suggested that most large scale financial developments or innovations could be ultimately traced to the specific investment needs of global finance and that very often these needs were met through the collusion of finance and state authorities.

...globalisation is real. It can be exaggerated, but change there undoubtedly has been. State power, on the other hand, still exists and can be – as has been – used to limit the local consequences of globalisation. The erosion of national controls over banks and non-banks, however, shows this state power is increasingly shared with markets, enterprises and non-state authorities.

(Strange, 1998a, p. 21)

¹ This case studies are based on a series of interviews which were conducted in 2001 to 2002 in connection with the DETR/EPSRC LINK Project: A Standardised Framework for Risk Assessment in the Management of PFI Projects. Participants in the interviews included senior public sector managers who headed the respective PFI projects as well as senior bank and other private sector representatives. All interviews were pre-arranged with key questions being forwarded to the interviewees a week or more in advance. Most interviews lasted over one hour, and were tape recorded and professionally transcribed. In both case studies, the interviews were supplemented by contract documentation which were made available to the researchers by the Special Purpose Vehicle.

Strange's analysis of emerging financial arrangements allows for several interpretative possibilities; but points to the possibility of only one likely trajectory with regard to an increasing hegemonic position of finance capital. On the one hand, one could argue that global finance provides new, non-traditional, means for states to meet their obligations. Accordingly, PFI would fall neatly into a picture where governments, which themselves have created fiscal pressures, adopt PFI as a means of tapping into global surplus capital (Cohn, 2004). However, this interpretation of a state led financial transformation of public service provision leaves much to be desired, if only because it fails to explain why this transformation were to occur at this late stage of neo-liberal policy making.

The alternative, and perhaps far more credible, interpretation is one in which finance capital is itself the driver for the creation of PFI with the state acting as facilitator and broker. Susan Strange's masterpiece *The Theory of Mad Money* (1998b) primarily focuses on the impact of what she describes as "Casino Capitalism" on developing countries who have suffered most from monetary destabilisation and financial crises. However, Strange also focuses on the more peripheral effects of these developments, namely the desire of global finance capital to balance its portfolio with lower risk lower return investments in relatively stable regions. These "tame" investments take many forms, they target low-risk government bonds but also participate in project finance. They are conducted by established investment houses, but they also involve pension funds (in any case the dividing lines between investor-types are far too opaque to draw out relevant distinctions). One obvious interest of this "hunt" for low-risk income is an increase in state sponsored--and hence relatively safe--investment opportunities such as

those offered by PFI projects. While it is beyond the scope of this paper to document the growing involvement of global finance in UK PFI, it is perhaps worthwhile to point out that studies in other PFI-rich regions have been able to successfully identify the lead role played by financiers in lobbying for an expanded role of PFI. Thus Cohn (2004) finds a close link between the need of Canadian pensions funds to invest capital and the expansion of PFI investment opportunities in Canada, while Spackman (2002) implicitly acknowledges that the adoption of PFI in the UK over cheaper “Design, Build, Operate” (DBO) and “Design, Build, Finance and Operate” (DBFO) options can be attributed to the preference of financiers for the relatively safe long-term returns offered by PFI projects.

PFI, from this perspective is far less about states using finance capital in order to meet obligations to the public, than about global finance finding additional low-risk investment opportunities post the Asian and Russian financial crises. This status of PFI as investment opportunity for private finance, needless to say, is not without its effect with regard to the nature and structure of the resulting “partnership”.

Finance Capital and Institutional Decision Making

Theoretical arguments asserting the power of finance capital in shaping the policy of institutions have an extensive academic pedigree, which ranges from the writings of Hilferding (1910, 1981) to the more recent works of Aaronovitch (1961) and Glasberg (1989). As a general tenet, the finance capital literature proposes that there is a close

relationship between the power of financiers to influence institutional decision making on the one hand, and the level of dependency of the client institutions, under conditions of uncertainty, on the other hand. In other words, it is argued that financial institutions are more likely to shape institutional decision making where their client is heavily dependent on their input and where the financial sector itself is taking risks in providing the requisite capital to that client.

In one of the earliest formulations of this relationship, Hilferding noted that:

The development of capitalist industry produces concentration of banking, and this concentrated banking systems is itself an important force in attaining the highest stage of capitalist concentration in cartels and trusts. How do the latter then react upon the banking system? The cartel or trust is an enterprise of very great financial capacity. In the relations of mutual dependence between capitalist enterprises it is the amount of capital that principally decides which enterprise shall become dependent upon the other.

(Hilferding, 1910, quoted from the 1981 English translation, p. 223)

Hilferding's analysis was echoed more than fifty years later by Aaronovitch (1961) who argued that:

In financial institutions, more than in industrial combines, great sums of money are under the control of a limited number of people who themselves own directly only a small fraction of the actual capital. When these individuals are closely

linked with the dominant shareholders and controllers of industrial enterprises, or become those very people, the concentration of control is greatly increased.

(Aaronovitch, 1961, p. 43)

According to Aaronovitch this domination manifests itself in the degree of self financing which some industrial conglomerates are able to provide, whereby self-financing itself “has nothing to do with ‘independence’ but only with the policies pursued by the largest groups” (Aaronovitch, 1961, p. 47). Aaronovitch further observes that the power of finance capital has been underpinned by the fact that “there is hardly a large combine in Britain today which is not professionally advised by one of the merchant banks and which has not got insurance companies among its substantial shareholders” (Aaronovitch, 1961, p. 48).

The patterns of finance capital control highlighted by Aaronovitch have in many respects intensified with the involvement of private capital in public projects. Over recent years, many financiers, who had traditionally provided the main project capital (80-95 per cent of the project requirements) for projects, have also become involved in equity provision; thus acquiring additional influence over the “self-financing” component of PFI projects. In most cases these financial involvements are carefully targeted, with some senior debt providers explicitly requiring certain levels of participation in the equity stakes. The position of finance capital in public sector projects is strengthened by the fact that the majority of the well established PFI financiers in the UK adopt multiple functions when involved in PFI projects. Thus, in some transactions they act as senior debt and/or equity

providers for the private sector project company, while in other transactions they are involved as advisers to public or private sector partners.

While Hilferding has depicted conditions of oligopolistic banking which, to a large degree apply to the contemporary PFI market in the UK, the applicability of his analyses is limited to the current PFI context on account of his failure to anticipate the large-scale merger of, or collusion amongst banks. This issue has been addressed, *inter alia*, by Glasberg (1987, 1989) who investigated the influence of finance capital on both private and public sector organisations. In her 1987 article “Finance Capital and the Corporate Decision Making Process”, Glasberg concluded that:

The conventional view of the business structure is based on the assumption of free and open competition, presumed to censure that only the most efficient forms would survive. Day-to-day consultation between banks, however, contradicts this viewpoint. The banking community resides in a structural arrangement that necessitates banks’ cooperation instead of competition.

(Glasberg, 1987, p. 325)

Investigating the characteristics of finance capital Glasberg further noted that:

What is significant, however, is the fact that finance capital is ultimately the most critical resource: it is the only resource for which there are no alternatives. ... Moreover, the structural hegemony of the banking community, produced by the

legal and financial necessity of lending consortia, erodes the competitive nature that may be present in material resource industries. Finally, finance capital is more than a resource: it is a relationship, that unlike the temporary alliances characteristic of material capital supplier arrangements, has long-term consequences. ... [F]inance capital relationships cannot be broken without deleterious consequences (since banks typically recognise and honour each others' customer supplier relationships and since they are collectively the "only game in town"). Hence reliance on finance capital as a resource is unique to all other resource dependencies and should be considered specifically and separately from a general resource dependence model.

(Glasberg, 1987, p. 327)

Glasberg's analysis is relevant to the context of contemporary PFI at several levels. PFI projects cannot be implemented without the prerequisite of private capital, operating globally or otherwise; and providers of private capital will, within a certain range, apply similar risk-return criteria to evaluate their involvement in a project. In other words, where projects only marginally meet the expectations set by banks, adjustments have to be made to project characteristics or content, the guarantees given by contractors, or the payment mechanisms selected, in order to allow for the project to proceed. Structural dependence on private capital, in this sense, is an ever-present feature of PFI procurement, but it is only likely to become an explicit part of PFI negotiations where the expectations of banks are not fully met. However, even where these expectations are met, some level of structural dependence will be implicit to the PFI deal, in the sense that

the public sector client will have already anticipated what constitutes an acceptable deal and will have adjusted its service provision “requirements” accordingly.

Much of the deal shaping efforts of private capital centres around ensuring that certain risk-return criteria are met. One of the key financial risks in this context is the creditworthiness of the public sector partner. As concerns the creditworthiness of the public sector partners, financial services providers appear to have become less concerned as PFI procurement has matured. In any case many of the concerns which financial services providers did have were historically related to the contractual standing of public sector clients, and local authorities in particular, rather than their solvency. Thus, in the UK, conflicts had arisen in the early and mid 1990s over the interpretation of Section 111 of the Local Government Act 1972 in connection with PFI projects. Section 111 of the Act had given local authorities considerable leeway when entering contractual partnership. This authority was scrutinised by the clients in a number of cases, including *Credit Suisse v London Borough of Waltham Forest* [1996] 4 All E.R. 176 and *Credit Suisse v Allerdale Borough Council* [1997] QB 306, which led to a narrower interpretation of the standing of local authorities and, as a consequence, created significant legal risks for private sector partners involved in PFIs. In *Credit Suisse v Allerdale Borough Council* [1997] QB 306, the court found a guarantee, given by a council to a company it set up, to be void on account of its lack of power to give such assurances. This legal risk was largely removed through the passage of the Local Government (Contracts) Act 1997, which imposed not only certification requirement on

public sector clients, but also created arrangements for the compensation of private sector parties.

The concern of financial institutions therefore shifted from legal risk to concerns over affordability and revenue generation. Such affordability issues have arisen, *inter alia*, from the statutory protection of subcontractors such as the Housing Grants, Construction and Regeneration Act 1996 and similar legislation. This legislation implicitly limits the degree to which contractors can pass risks to subcontractors and, as a consequence, makes it important for financial services providers to ascertain the solvency of the main contracting parties during the construction phase. Concerns over revenue generation are intrinsically related to the contractual stipulation of many PFI contracts. As an example of such stipulations, the 1999 Defence Procurement Agency's guidelines on PFI payment mechanisms states that:

- there should be no payment until the agreed level of service has been certified as being available;
- a single “unitary” payment should be made for the service and this should only be paid if the service is provided;
- a common level of price should be paid for a common level of service (i.e. aside from exceptional circumstances the price for a given service should not vary significantly in real terms over the life of the contract);

- deductions should be made for substandard performance so that the supplier is worse off than if the required service had been delivered - deductions should reflect the severity of failure, so that no service should lead to no payment, but a minor failure should only cause at most a minor deduction;
- suppliers should not automatically be given higher payments for exceeding performance requirements although MOD may in some circumstances agree to pay more if additional Value For Money benefit can be delivered within affordability limits;
- no elements of the unitary payment should relate simply to the completion of project milestones or the delivery of assets

(Defense Procurement Agency PFI Group, 1999, pp. 2-3)

These conditions are fairly typical of PFI contracts in other areas, and it is clear that the need to meet these requirements encourages financiers to focus on relevant PFI risks.

The following two case studies investigate the involvement of financial services providers in two PFI projects with a special emphasis on the risk assessment by the brokering banks. The focus of this analysis is on the decisive role played by financial services providers in structuring the conditions of the deal and in shaping the service mix provided by the public sector client. The two case studies were selected from a total of eight detailed studies of PFI projects which were conducted in connection with the

aforementioned research project (see footnote 1). The main criterion for the selection of these the case studies was their ability to illustrate the broad range of ways in which banks directly and indirectly influence decision making during the procurement of PFI schemes.

Case Study A: Housing Accommodation

The first case study details a mid-scale PFI-based housing project. The client of this project was a local branch of a central government agency with experience of contracting with the private sector. The project was located in a remote and under-populated geographic area and involved the design and construction of nearly 300 houses for government agency employees as well as the maintenance of the facilities over a period of 25 years. The requirement for the accommodation emerged in connection with the need for an urgent relocation of employees, which also imposed very tight time scales.

The project company which was selected to undertake the works included two construction companies and a bank which together established a joint venture (see Figure 1). The capital requirement for the construction phase of the project was in the range of £26 million, while the overall cost of the project over the concessional period was estimated at £72 million. The members of the private sector project company, also known as Special Purpose Vehicle (SPV), supplied 10% of the capital requirement, while the remaining 90% were financed through senior bank debt. The bank provided both the senior debt and the equity for the development. In order to reduce the transaction risk associated with contracting with a separate company, the SPV members sub-contracted

the facilities management services to a subsidiary of one of the construction companies (see Figure 1).

Figure 1 here

Figure 1: Organisational structure and key participants.

As part of the project agreement, the unitary charge, which had to be paid by the client on project completion, was to be split into three parts. These included a charge for capital re-payment, one for maintenance over the life cycle, and one covering the equity which had been provided to the project. A relatively high proportion of the unitary charge, 90%, was fixed and only 10% was variable with a capped value related to the Retail Price Index.

A senior manager representing the client noted in interviews with the authors that the bidding process was conducted in accordance with detailed government guidance and therefore did not represent any unexpected challenges to the, in any case, experienced project team. However, the team was conscious of time restrictions and aimed to speed

up the procurement process. Consequently, the negotiation period between the selection of the preferred bidder and the financial close took only about 10 months. This was followed by a construction phase of 18 months, resulting in the timely completion of the project.

In order to facilitate the risk identification and evaluation during the pre-qualification phase, the public sector client organised five meetings with perspective bidders. These meetings served to discuss and clarify project risks and offered the client an opportunity to apply its “shadow” model to assess the cost implications of the different options proposed.

In its analysis of potential risks, the public sector project team identified three key risks which were likely to affect the goal of achieving off balance sheet project treatment. These included demand risk, availability risk and residual value risk. The availability risk was mitigated through the development of a robust payment mechanism including a pre-agreed scoring system accounting for faults and defects. The demand risk could not be effectively mitigated as there was a possibility that the central government agency would relocate or close the facility. In order to reduce this risk, and to ensure compliance with the bank’s wishes, the client included a contractual clause stipulating that, after the sixth operational year it could step down a maximum of ten houses per year. These houses would then become non-core stock owned either by the client or the SPV, which would reduce costs to the client. As concerns residual value risk, efforts at risk mitigation proved even more problematic due to the banks unwillingness to accept this

risk on account of the remote location of the project and the lack of a buoyant housing market in that area. These considerations were confirmed by a senior public sector manager who noted in an interview with the authors that, even at current conditions, after the fifth year the costs of the buildings were likely to exceed their market value. On account of these problems, the project's risk profile attracted considerable debate in government circles, particularly in relation to demand and residual value risks. After examinations conducted by the National Audit Office² (NAO), the relevant government authorities decided eventually that the project could not be subjected to off balance sheet treatment.

The main difficulties encountered in this project related to the achievement of off balance sheet treatment in parallel with Value For Money. These problems were aggravated by changes in government accounting regulations introduced shortly before the financial close. Specifically, the Accounting Standard Board had modified the existing accounting standards in relation to the balance sheet treatment of risks, in a manner which required the project team to re-evaluate the estimates. This had a significant knock-on effect on the client. As it became clear that off balance sheet project treatment could not be achieved, there was a danger that the whole project would fail due to financial restrictions arising from central government regulations. Once the project team was able

² The National Audit Office is an organisation independent of British government which acts on behalf of Parliament with an aim to audit and review public spending. The areas of investigation cover the performance of all kind of government departments, agencies and other public bodies. The National Audit Office has produced a number of reports on the economy, efficiency and effectiveness with which government bodies have used public money.

to demonstrate considerable overall savings between the PSC³ and the risk adjusted private sector bid, however, the Treasury felt that it could approve the project.

Case Study A: Risk Assessment and Management by the Bank

The bank's project team gathered initial ideas about the risk portfolio of the project immediately after the publication of the Official Journal of the European Community (OJEC) notice. Since each SPV member had experience in PFI procurement, the view taken by the bank was that the location of the project was not of substantial concern. The building and the operating companies had the same parent company, which was expected to facilitate collaboration between SPV members.

The bank's efforts were centred on the financial model. This model assessed the probabilities of different risks occurring with input provided by external experts. The main risk categories that were evaluated in this project included life cycle costs, land suitability, design planning and availability risk, and risks related to the transfer of old property. Risks associated with life cycle costs were to be managed by distributing these expenses through time and by accumulating a cash reserve in order to smooth the life cycle cost curve.

When investigating the land suitability and land condition risk, the bank recognised that the most suitable piece of land was owned by another construction company. This led to the decision to create a joint venture which involved the second construction company in

³ In this case the PSC was audited by the NAO.

the project. As concerns the design and planning risk, the bank considered that the design brief provided by the client was sufficiently prescriptive to reduce these risks to a negligible level. Availability issues which could arise in case of latent defects were a major concern for the client and consequently required special measures. Therefore, a points system was created in collaboration with the public sector client where each particular defect was assigned certain weight and a house was considered unavailable once the total score exceeded a particular number.

During the interview, the bank representative noted that one of the principal goals of his organisation was to ensure that the risks which were transferred from the client to the SPV were in turn transferred to the subcontractors (construction and operational companies). Some risks that could not be transferred, such as the risk associated with ground conditions, had to be priced by the SPV. Only after the appropriate premiums were added was the bank willing to consider these risks as being reasonably mitigated.

In this project, the consortium became the preferred bidder primarily on the basis of its ability to quote the lowest overall project cost in terms of net present value. In order to achieve this result, the pricing of risks took into account the limitations of capital price and operational prices. As part of the due diligence before the financial close, the pricing provided by the SPV was vetted by the bank's external consultants. The soundness of the model was re-examined on several occasions, especially at the Invitation to Negotiate (ITN) and Best and Final Offer (BAFO) stages. This assured the financial services provider that the structure and content of the model were acceptable. The most important

input categories of the financial model comprised of costs, revenues and economic inputs. The input costs were classified into two categories: up-front costs and on-going costs (Table 2).

Other inputs were based on the bank's term sheet which set the length of the lending period, the up-front fees and the on-going fees. In addition the model incorporated information on the revenues and how they were expected to behave over time. Special attention was paid to a correction factor, which was used to moderate the predetermined value of the RPI. This factor is frequently used by the client to mitigate the inflationary risk and/or to achieve more favourable price estimates. For example, if the long-term operational costs were inflated with a coefficient equal to the RPI (Figure 2), the shareholders profit could grow very fast over time. Therefore, the variable costs are usually inflated by a factor proportional to the RPI⁴. The bank was closely involved in the calculation of this correction factor which ultimately had to satisfy both the shareholders and the public sector client.

Table 2 here

Table 2: Main costs considered in the financial model.

⁴ While the Treasury Taskforce recommends the long-term value of the RPI, the public sector client can use a discretion regarding the value of the correction factor. Moreover, the value of this factor can be used to judge the level of competition in particular project.

Other inputs were based on assumptions about the future behaviour of some economic variables, such as the corporation tax, the RPI and VAT, which accounted for the existence of systematic risk factors. The interaction between several variables over time was assessed in the model to produce outputs such as a profit and loss account, a balance sheet and cash flow projections. The outputs estimated the level of retained cash, the corrected total cost curve, the ratio maps against base cover ratios, and graphs of shareholder's return. Some of these outputs were used to justify certain expenses to the client.

Figure 2 here

Figure 2: Development of project costs over time.

There was clear evidence that the bank's concerns with managing the risk-return profile of this project had a crucial impact on the way the public sector had to structure its approach. This was most evident in the fact that the public sector client ultimately had to consent to the bank's refusal to accept the transfer of the volume risk to the SPV. As a

consequence, the client had to retain volume risk and was unable to document a sufficient level of risk transfer. This, in turn, meant that the client was unable to achieve the off-balance sheet treatment conventionally available to PFI projects. In terms of accountability from the client's perspective, the process by which this project was procured along PFI lines but not accounted as such, must be considered highly unsatisfactory. However, much of the underlying negotiations never became a matter of public record, primarily due to the commercial confidentiality requirements imposed by the private sector partners.

Case Study B: Waste Management Project

Despite the development of new modern technologies for waste processing, the majority of UK local authorities dispose waste at local landfill sites and currently only 3% of the waste is being recycled. In response to the EU Landfill Directive for waste recovery which aims to move waste from landfill, two local authorities decided to engage in more sophisticated waste management solution. Both authorities sought to implement a high-tech solution which would provide a number of advantages, such as retrieval of materials for recycling, composting, energy production, and using fuel produced from the waste for generating electricity. Since this project required substantial up-front capital investment to finance the processing equipment, the clients "opted" for PFI-based procurement.

In early 1997, the client issued an OJEC notice and received a dozen applications from potential bidders. Six of these companies were invited to prepare more detailed formal

submissions, and three were approved for the next selection stage. After careful consideration of three bids in 1998, the clients selected the preferred bidder who offered different and distinctly innovative solution. The bid was submitted by a foreign company with an established position in recycling and waste recovery. The company was looking for an opportunity to enter the UK waste management market. Therefore, the management of the company was prepared to take higher levels of risk as compared to the domestic companies.

By entering into a partnership with a little known in the UK foreign company, the clients appeared to take on additional risks. Moreover, accepting innovative but unproven technology created uncertainties. The proposed plant was designed to achieve 25% recycling, while the current recycling levels were about 6%. According to the contract, it also had to reach 30-40% composting and about 35% for energy recovery. Therefore, it was processing on average of three-quarters of the waste stream away from the landfill with 49% material recovery. In order to encourage the SPV to exceed these targets, the contract imposed further incentives which were based on an overall expected level of recovery around 70%.

The negotiations between the public sector representatives and the bidding consortia begun in 1998 and planning permission was granted two years later. The agreement was signed during the second half of 2000, specifying that the plant had to be fully operational in two years time. The construction value of the contract was in the range of £33 million with a concession period running for 25 years. The plant was to generate

income mainly through the waste gate fee, and a small proportion of its income was to come from recycled materials.

The organisational structure for the project is depicted in Figure 3. The main parties comprising the SPV included: sponsor 1 – construction and engineering company (51%), sponsor 2 – Local Authority’s Waste Management Company (20%), and sponsor 3 – external equity provider (29%).

Figure 3 here

Figure 3: Organisational structure and main project participants.

The capital requirement for this transaction was provided primarily through a bank loan (87.5%), while some equity was supplied by the project company and an external equity investor (12.5%). The local authorities also participated with an equity stake through a specifically created company, probably in the hope that this would send encouraging signals to the lender.

Table 3 here

Table 3: Risk distribution between the public and the private sector

The high degree of risk transfer to the private sector in project B is illustrated in Table 3. In addition to the more or less standard planning design and construction related risks, the private sector partners had to accept a range of commercial and technological risks, including an additional tax in case that the landfill conversion targets were not fully met.

Case Study B: Risk Management from the Perspective of the Senior Debt Provider

At that time of the OJEC notice, the bank did not conduct any risk analysis, but merely indicated its potential interest in the project. Thereafter, an internal team of four staff members was established later on to work on the transaction. More serious involvement in the project developed after the short-listing stage.

According to the bank representative, the key risks in this particular project were identified at the outset because of the bank's existing experience in both PFI procurement and construction-type projects. The view adopted by the bank was that, under the PFI regime, the risks facing financiers were closely allied with the risks of the borrower. Therefore, the bank was determined not to take any risks which their organisation could not control and was unwilling to allow the construction and facilities management

companies to do so. Considering the non-recourse features of the PFI borrowing and the limited resources commanded by the SPV, the bank therefore insisted that all major risks, which were passed from the public sector, had to be allocated to the sub-contractors.

The bank's own risk identification process was predominantly based on the project documentation and involved a combination of internal expertise and external advice. The bank's risk assessment process was primarily semi-quantitative and based on the financial model.

At the pre-qualification stage the bank insisted that key commercial risks which had to be properly allocated in a manner which would allow it to secure senior debt provision. These risks were understood as "deal breakers" and related to the construction and operational activities. As concerns the construction risks, the bank applied the general rule that the main construction risks of time and cost overruns had to be transferred to the companies involved in the construction process. Due to the fact that there were four construction companies involved as sub-contractors (some of them being divisions of the main engineering company), the bank anticipated problems with joint responsibility. In order to avoid such problems, the bank insisted on establishing a contractual structure that would create a single interface with the borrower. Consequently, one company took the responsibility for all construction risks.

As concerns the operational risk, the bank insisted that the covenant of the SPV members be investigated in terms of their ability to manage risks which included their historical

delivery track record. This information was used to determine the level of the caps on liability with regard to performance. According to the bank representative, during the BAFO stage the bank used legal advisers to investigate the contractual documentation, but did not require a detailed investigation of the project risks. A comprehensive risk analysis was conducted at the preferred bidder stage when, in addition to legal advisers, the bank involved technical and financial advisers. The financial advisers acted as auditors to the financial model. They paid particular attention to a number of aspects, such as compliance with legislation, the reliability of calculations, and the correspondence of the model to the features of the commercial transaction. In order to judge the project's financial performance, the bank used the financial model to calculate some key financial ratios, such as the annual debt service cover ratio (ADSCR) and the loan life cover ratio (LLCR). The ADSCR was calculated as the cash revenue available for debt service divided by the amount of debt in the corresponding year. It was used to indicate the ability of the SPV to pay its debt. The LLCR is defined as the NPV of the sum of all future income for the life of the loan divided by the outstanding debt at particular point of the time. Both ratios were investigated in terms of critical values which had to be observed through the life of the project.

In addition to analysing and modifying the main contract, the bank investigated the construction and operations/maintenance sub-contracts. In this context, special attention was paid to the risks affecting the recycling and electricity generation facilities, as they had to provide 20% of the payments stream.

Ultimately the financier brokered a risk sharing pattern between the three parties, which involved the SPV passing some risks to the client and others to the sub-contractors. As the main construction and operation risks were laid off, other important risks considered by the bank were addressed by due diligence and partly by investigating the sensitivities. However, due diligence and sensitivity analysis was used only after the main “deal breaking” risks had been mitigated. Some specific risks investigated in this project were related to the possible changes in the recycling market, the landfill capacity risk and changes to the electricity market.

Particular issues that concerned the bank included changes in terms of quantity and composition of waste and their corresponding effect on the prices, as well as changes in the UK electricity market.

At the preferred bidder stage the bank received a version of the concessional agreement and commented on the proposed risk allocation. Afterwards, when the lawyers to the SPV drafted the sub-contracts, these drafts were also sent to the bank. After careful investigation of these documents, the bank had “concerns” regarding the appropriateness of the risk distribution. Most of the time the bank, however, was not directly involved in the negotiations between the public and private sector partners. As a consequence, the iterative process of negotiating and agreeing contractual details took a couple of months. Towards the end of the negotiations, the bank conducted due diligence procedures, which scrutinised the risk identification, evaluation, and allocation by involving judgements from top experts. Due diligence also effectively served as a tool for laying off risks to

the companies involved, since in case of operational problems with the financial model, the auditors would be held responsibility for them⁵.

On the instance of the bank, construction and operation risks (and as a form of insurance) were eventually mitigated through the use of construction bonds. These construction bonds are payable from another bank which acts as an insurer and guarantee the availability of a certain amount of capital if the project company is insolvent, the construction contract is terminated, and the bank has to incur additional costs to complete the project with another company. In this project, the senior debt provider received construction bonds not only from the main project company, but also from the major sub-contractors, which covered about 20-30% of the construction value of the transaction.

One of the major risks that the bank was trying to assess during the negotiations was related to the landfill capacity available. Discussions were held to clarify the impact of unforeseen difficulties which could jeopardise the re-cycling waste targets. Subsequently, a special agreement was signed with a third party with a landfill license, in order to mitigate this risk.

While, ultimately, the financial conditions were met for this project to be treated off-balance sheet, this project suffered from repeated interference by the financial service provider which prolonged initial negotiations. By opting for apparently innovative solution, the public sector client had created particular risks, which the senior debt

⁵ As a rule, external experts have an insurance cover for such risks and their liabilities are limited to a

provider was not willing to accept unless specific, and by PFI standards unusual, arrangements were made. The arrangements affected both the construction company and some of the subcontractors, who were required to supply construction bonds in order to placate the concerns of the financiers. The cost of these special arrangements were passed to the client and, ultimately, significantly increased the cost of the project to the public; as did the bank requirement for a special third-party agreement regarding the use of an additional landfill site.

5. Discussion

Despite the differences between the two schemes, the approaches of the financial institutions to the “financial management” of these projects were broadly similar. The key consideration of the financiers was that, under PFI procurement, their risks were allied with the risks of the borrower, the SPV. Therefore, a series of actions were taken to ensure that an “acceptable” approach to risk management had been taken. In this context, the banks scrutinised the contractual risk allocation while attempting to ensure that all important risks were passed through the SPV to the parties that had definite control over them. Meanwhile, the capital providers themselves largely steered clear of substantial risk taking. Very few residual risks were allowed to remain with the SPV and even for those risks, the financiers required strong evidence, particularly in terms of past experience, skills and resources. For the financiers, the “proper” allocation of crucial commercial risks was a key criterion for determining the “financeability” of the particular transaction. Most risks were investigated on the basis of the full contractual

certain percentage of the damages.

documentation, including the main project agreement and the supplementing sub-contracts. Once the main project risks were mitigated, the residual risks were then assessed in detail in the course of the due diligence. In case of the first project, the risk assessment process conducted by the financial services providers led to the allocation of demand risk to the client, which ultimately made it impossible for the project to be treated off-balance sheet. In case of the second project, concern by the financial services providers led to the introduction of construction bonds and other guarantees, which arguably increased the cost of the project to the public sector.

Past research has attributed comparatively little importance to the role played by financial institutions in PFI procurement. This omission is problematic for several reasons. Firstly, any study which underplays the role played by financial institutions in PFI procurement is likely to ignore the genuine material considerations which make and break PFI deals. PFI's, viewed from an economic perspective, do not stand in a financial vacuum. Rather, their scope and feasibility is intrinsically linked to the expectations of those operating more or less collectively within financial markets. As such, the feasibility of conducting PFIs in general depends on those market conditions which at a given time favour the financing of PFIs, but will not necessarily do so in the future. Secondly, decision making on PFI projects is hardly a political process in the traditional sense. Rather, when due attention is paid to the role of financiers in PFI, it is a process which is conditioned primarily by the expectations and requirements of individual suppliers of finance capital. These expectations take precedence over other considerations, including the public sector's quest for innovative or high quality services.

In this sense, the relevance of research into PFI risk management arises not from its descriptive value, but rather from the fact that the views of the financial sector companies on the riskiness of projects and appropriate measures for risk mitigation concretely constrain the range of possibilities available to individual PFI projects. As principal players in PFI projects, senior debt providers determine to large degree what presents a commercially acceptable project. As such, they can dictate which measures other PFI participants must undertake in order to gain their approval. The application of these approval criteria is implicit to the PFI procurement process. In other words, financial service providers do not upfront prescribe how others must structure a project in order to ensure participation in a project and the availability of finance. However, where these requirements are not met, finance will ultimately not be available. With regard to the issue of accountability in PFI projects, it must therefore be understood that the prerequisite of obtaining capital from the private sector will inevitably limit levels of openness and discussion on crucial financial and project parameters. Financial services providers rarely disclose the details of their financial models or their risk assessment procedures. What is relevant to them are not minute project details but rather questions about the allocation, mitigation and retention of key risks; and very few of these details are subject to public scrutiny.

PFI procurement, at least in theory, is premised on the assumption that mutual gains will arise from the partnership of public and private sector organisations (HM Treasury, 2003). Against this rhetoric of PFI, as well as the assumption that there are readily

available recipes for introducing accountability into PFI, stands the simple fact that these deals can only be concluded if the risk-return criteria set by the financiers are met.

As the UK enters a second decade of PFI procurement, it is perhaps appropriate that we reflect more carefully, not only on its social and economic costs, but also on its increasingly obvious negative political implications. Today, PFI procurement in the UK, and elsewhere, carries the possibility of establishing a new legacy of anti-democratic public sector governance which has the very real potential of undermining what little is left of the democratic aspirations of post neo-liberal societies.

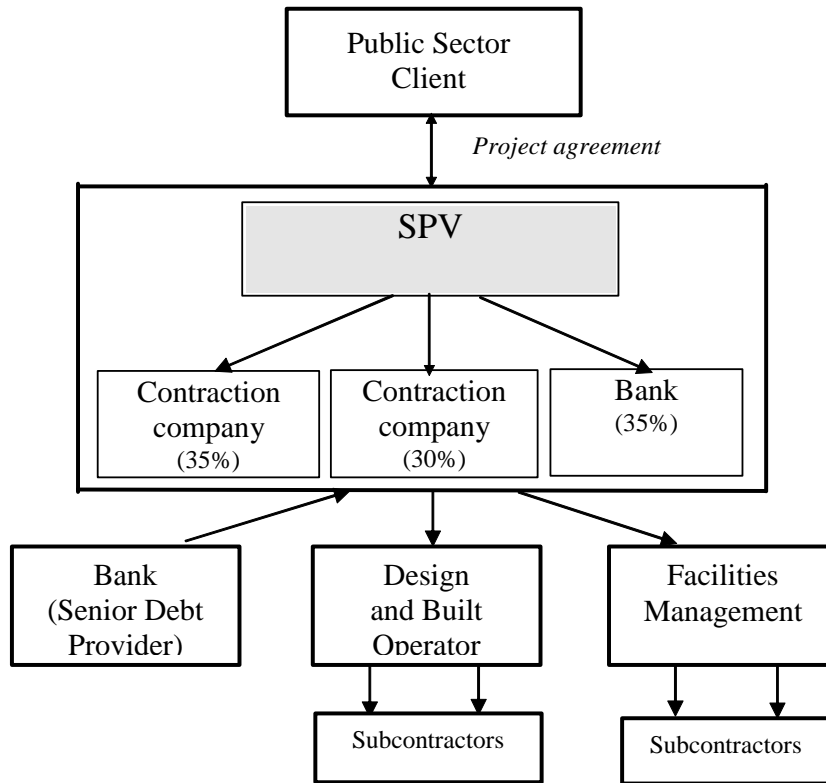


Figure 1: Organisational structure and key participants.

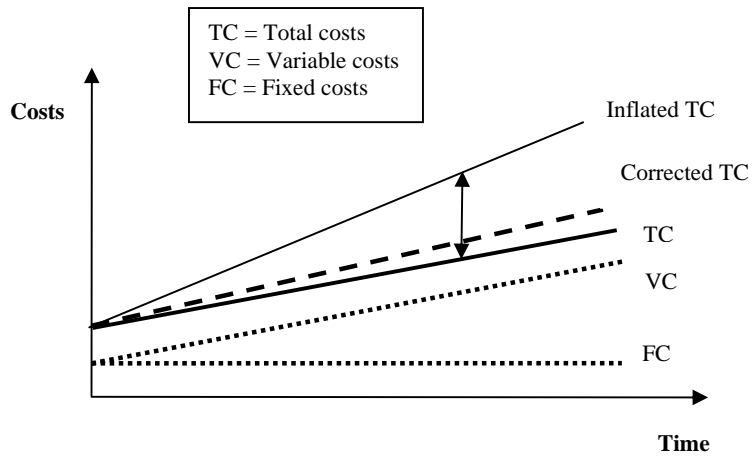


Figure 2: Development of project costs over time.

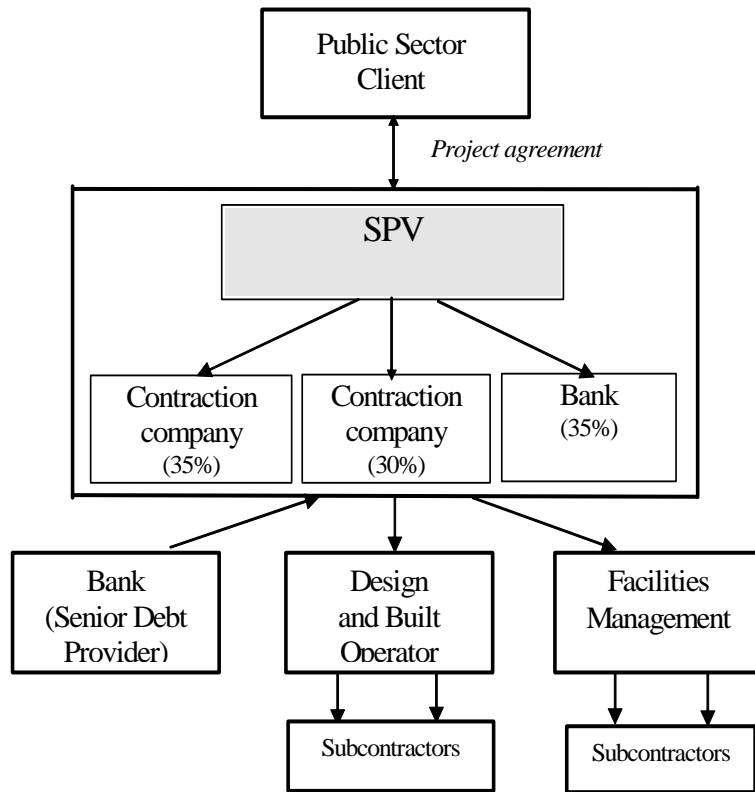


Figure 3: Organisational structure and main project participants.

Table 1: Distribution of the major risks between the public and the private sector partners.

Main Risks Allocated to the Private Sector	Main Risks Retained by the Public Sector
Construction risks including time and cost overruns	Interest rates before financial close
Availability and quality of facilities	Occupant generated damages
Financial risk – the SPV gets fixed price bank debt through an IR swap	Financial risk – the difference between the contractual swap rate and the real IR rate is paid by the client
Life cycle costs	
Facilities management – fixed price subcontract	
Old property available	
Provision of land	
Performance of the technical consultants	
Interest rates after financial close	
A degree of residual value	

Table 2: Main costs considered in the financial model.

Up-front costs	On-going costs
Construction costs	Life cycle costs
Up-front facilities management costs	On-going facilities management costs
Up-front shareholders' costs	On-going shareholders' costs (e.g. audit, insurance)
Bank's due diligence costs	On-going bank costs
Up-front advisers' costs	

Table 3: Risk distribution between the public and the private sector

Risks Transferred to the Private Sector	Risks Partially Retained by the Public Sector
Planning, design, construction time and cost overruns	The price of the electricity off-take
Latent defects and system failure	A degree of financial risk, particularly some limited recourse for the finance provision in case of force majeure conditions.
Other performance related risks	A limited degree of waste stream composition risk that could affect the recycling targets (shared).
The SPV will have increased tax obligation if landfill conversion targets are not fulfilled	Landfill tax
Risk from protestors actions	Changes in specific legislation
Commercial and technical risks	
Changes in general legislation	
Financial risks	

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