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UK PFI – recent measures further to improve delivery and management of PFI projects

In March last year, HM Treasury set out its up-dated approach to PFI in the document “PFI: Strengthening Long-Term Partnerships”. This document, building on the measures introduced since 2003, set out further improvements to PFI to support its ongoing important role in delivering better public services. These recent approaches include

- measures based on the Government’s research to build on the operational and contractual flexibility under PFI, including increased support to public sector managers during this phase of the contract;
- measures further to improve the ability of the public sector to understand where PFI is likely to offer better value for money than other procurement routes. This will be achieved by assisting procuring authorities in understanding the value for money of key decisions within a project including strengthening the test for the inclusion of soft services;
- measures to bolster the professionalism of PFI procurement to reduce procurement times. While improving, the Government believes that procurement times remain unnecessarily long and is introducing steps to improve the maturity of projects before they are tendered into the market, to reduce unnecessary uncertainty later in the procurement; and
- measures to support local decision making in PFI by through the provision of central skills and capabilities to ensure approvals are given at the right points in the process.

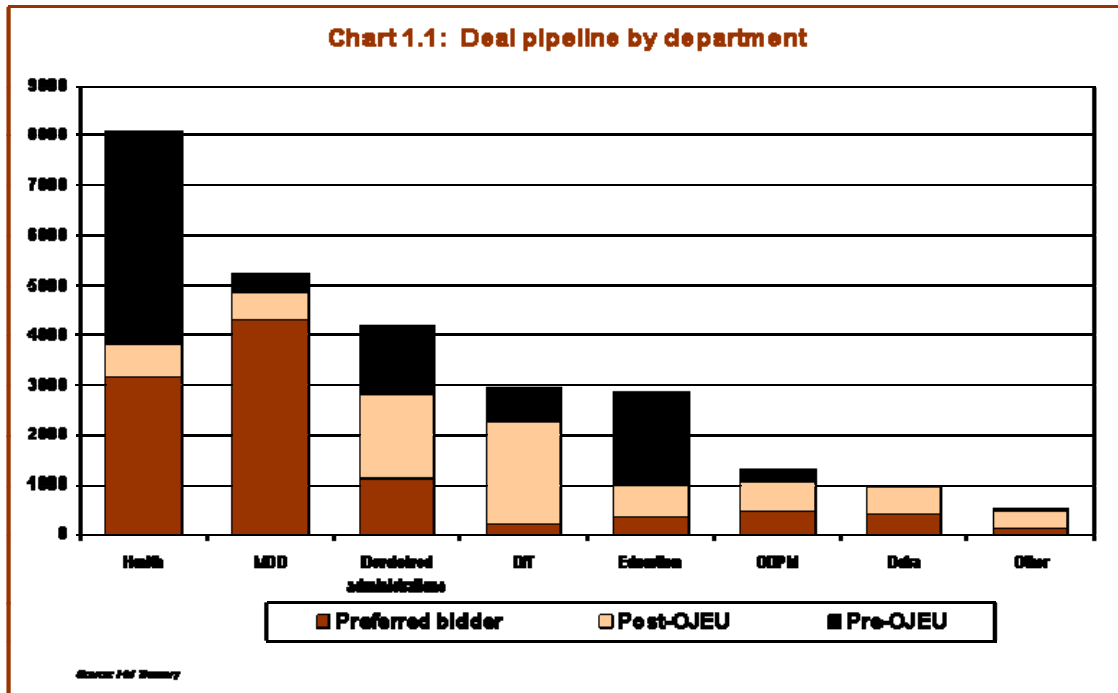
The remainder of this paper summarises the measures introduced over the past 3 years, the research undertaken and the steps that the UK Government is taking to improve continually the value for money and procurement of PFI.

Continuing to Meet the Investment Challenge

One of the UK Government’s long-term objectives is to deliver world-class public services. To achieve this, sustained increases in investment and reforms to deliver efficient and responsive services, which meet public expectations throughout the country, are needed. Strong and dependable public services lay the foundations for a flexible, productive economy. They also promote opportunity and security for all, helping to tackle poverty and social exclusion and improve the quality of life. PFI has continued to deliver new or modernised infrastructure for public services on time and on budget. PFI has now delivered almost 550 operational projects, including 207 health projects, 193 education projects and 59 transport projects.

Whilst the vast majority of public investment remains conventionally procured, PFI consistently makes up 10-15 per cent of public sector investment. This proportion has remained at roughly this level for a number of years. The balance sheet treatment of PFI is also not relevant to the decision about whether to pursue PFI as a procurement option, as this is based purely on the assessment of value for money. Around 50 per cent of PFI projects by capital value are on the public sector’s balance sheet.

PFI’s record of delivery means that the Government remains committed to using PFI as a procurement option where it is value for money to do so. There are currently around 200 projects with a capital value of £26 billion in the procurement pipeline to 2010. This represents one of the largest committed programmes of new investment in public service infrastructure through PPP and PFI projects globally. Chart 1. below shows the breakdown of projects in procurement by department (Ministry).



The Government's Approach to PFI and Value for Money

As mentioned, PFI is only one of a number of procurement options that the Government can use to invest in public services. The government only uses PFI where it can be shown to deliver value for money and does not come at the expense of employees' terms and conditions. PFI offers value for money for certain investments through: a long-term focus on whole life costs; risk management expertise; and greater certainty for the public sector that services will be delivered to the specified standard. Benefits are derived from PFI where the risks associated with a project are borne by the party that can best manage them.

Experience has shown that there is usually a range of procurement options, including PFI, that should be considered as procuring authorities decide how to undertake major investment programmes. These options include conventional design and build contracts, PFI, programme procurement vehicles such as are being used in Building Schools for the Future and NHS LIFT, and other approaches to partnering. The UK Government is continuing to develop ways to improve the procurement of new PFI sectors and is committed to pilot further project delivery organisations.

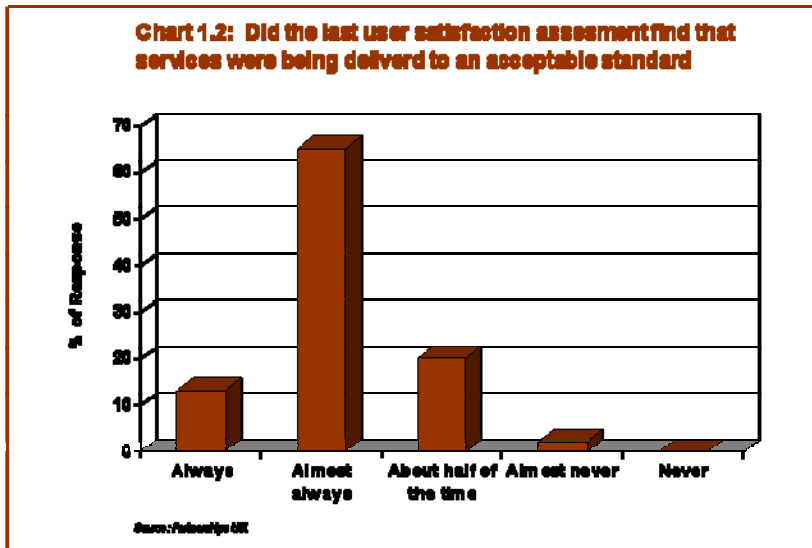
Improving the Value for Money and Operation of PFI Projects

Evidence on operational PFI projects

Research, recently commissioned by the Treasury from Partnerships UK on operational PFI projects¹ shows that 80 per cent of all users of PFI projects are always or almost always satisfied with the service being provided. The evidence from this research is also consistent with other studies conducted by government departments and other bodies. For example, the KPMG and business Services Association (BSA) study² found that users were satisfied always or most of the time in 81 per cent of cases.

¹ "Report on Operational PPP/PFI projects" Partnerships UK. Available on the Partnerships UK website (www.partnershipsuk.org.uk).

² KPMG / BSA, (2005) "Effectiveness of Operational Contracts in PFI".



Research also confirms that PFI contracts are delivering the services required under the PFI contract. Across all the PFI projects surveyed, 66 per cent of public sector managers believed that the service being provided was very good or good and 30 per cent believed the services to be satisfactory. Performance under PFI contracts has also been consistently high over time with around 90 per cent of PFI projects performing satisfactorily or better in every year since 1998.

An effective partnership between the public and private sector is central to a PFI project’s ability to deliver the services required and meet the expectations of the public sector. Public sector managers believe that they have developed an effective partnership with the private sector to deliver services. Over 70 per cent believe that their relationship with their private sector partners is very good or good. The incentivisation within PFI contracts is also working with around 80 per cent of public sector managers agreeing that the payment mechanism supports the effective contract management of the project. In just under 70 per cent of projects, levying payment deductions on the PFI contractor to reflect poor performance has led to improvements in the service being provided.

Improving the Operational Performance of PFI projects

While the research in general presents a positive picture of PFI in operation, the evidence points to a number of areas where PFI projects in operation could be improved further. These lessons can be grouped into two categories where operational performance and flexibility within PFI contracts can be improved to ensure that the public sector’s requirements continue to be met in the future and PFI could be refined to improve long-term value for money. Just as “PFI: Meeting the Investment Challenge” set out areas, based on experience, where PFI was less likely to offer value for money, the research into operational projects and recent experience has highlighted areas where the value for money of individual PFI projects could be improved further.

The steps the Government is taking to improve the operational performance of PFI projects are split between measures to avoid issues arising in the future and improving the performance of older contracts that are now operational.

PFI contracts are designed to allow the public sector to make changes in its service requirements that become necessary after procurement, through the variation clause in contracts. Whether the asset is procured conventionally or through PFI, the costs of such change need to be borne by the public sector. One of the key benefits of PFI is the requirement for the public sector to define accurately its requirement through an output-based specification and to consider and provide for mechanisms to

change its requirements over time. This is a discipline that does not generally exist within conventional procurement.

While generally the contract accurately specifies the services required, public sector managers believe that the levels of flexibility built into (generally older) contracts to undertake minor variations, could be improved. Evidence suggests public sector managers appreciate the long-term certainty over maintenance and service provision created by PFI, but want greater flexibility to make minor variations and greater alignment of incentives to agree and complete variations.

To ensure that variations can be undertaken more flexibly in future PFI projects, the UK Government is ensuring that the flexibility required is adequately assessed both when scoping the project's requirements and throughout the procurement process, in particular in the levels of flexibility offered by different bidders. This has been achieved through revisions to the "Value for Money Assessment Guidance". The Government is also improving the levels of support to contract managers and has created a PFI Operational Taskforce (described in Box 1) to support contract managers in undertaking variations and improving the flexibility of existing PFI contracts.

In response to PFI contract managers believing that they would perform better if they had increased involvement during the pre-operation phase, best practice suggests:

- The earlier involvement of contract managers during the procurement process to develop stronger relationships with the private sector;
- A more structured handover from procurement to operation, including a user guide to the PFI contract; and
- Authorities to consider using a period of shadow-running to test key aspects of the contract in an operational environment.

Box 1: PFI Operational Taskforce

To provide the public sector with greater support during the operational phase of PFI projects and to bring consistency to the public and private sector's approach to the key operational issues, the Government has created a PFI Operational Taskforce. The Treasury has used Partnerships UK to establish a Taskforce that is working with department Private Finance Units (PFU), 4ps and the private sector to provide proactive support to project managers on key operational issues while also providing greater consistency across older PFI projects. Key priorities for the PFI Operational Taskforce include:

- Improving the levels of guidance and support available to project managers who are approaching their first benchmarking or market testing periods;
- Proactively assisting the public sector on all operational issues faces;
- Considering a limited number of changes to the standard PFI contract that flow from an improved understanding of operational issues;
- Implementing the Refinancing Code of Conduct; and
- Collaborating with the Office of Government Commerce (OGC), the UK Government's procurement agency on a pilot scheme reviewing operational performance, to provide advice to project teams to improve ongoing performance management.

It is important that the public sector has the ability to reconfigure its asset base, more structurally than can be achieved within a PFI contract variation mechanism, to meet changing priorities. There will always be constraints on the public sector if its long-term requirements fundamentally change, whether the assets are procured conventionally or through PFI. The capital cost of constructing an asset to a particular specification will always have to be borne, even if the public sector's requirements fundamentally change. The PFI procurement process ensures that the cost, quality and outcomes of this flexibility are transparently understood and assessed. To ensure the PFI as a procurement option does not unduly constrain the public sector's choice of asset base required to deliver services, the UK Government will be:

- Setting sector specific concession length caps to ensure that the length of the contract is appropriate to the nature of the services and assets being provided. For example, where a PFI project has a large service element, the value for money of a longer-term contract is diminished; and
- Reducing the costs of terminating PFI contracts by changing its approach to certain aspects of the financial structure and the calculation of the payment made if the public sector wishes to terminate the contract.

The evidence of operational PFI contracts shows a high level of satisfaction with the operational performance of PFI projects overall. Analysis of performance under the different elements of the contract emphasises the benefits that PFI brings in terms of the general availability of the underlying asset, and its maintenance. The evidence shows that soft services are performing satisfactorily. All of the PFI hospitals, in cleanliness data examined by Patient Environment Action Teams in 2004, are rated at least acceptable. Research backed up by interview evidence from the survey of operational projects, illustrates that while 100 per cent or just less of projects in that sample rated their projects adequate or better on both availability and soft services, 91 per cent of those projects rated availability as good or very good, while 58 per cent placed soft services in the same categories. The evidence shows therefore that soft services are seen as performing less well on average than the very high scores given to other elements of the PFI framework.

The UK Government's view is that the evidence on satisfaction with soft services does not demonstrate value for money as consistently as other elements of the framework, and that the analysis of service outcomes suggests that while standards are no worse than in non-PFI structures, PFI has not led to a step change in soft service delivery. Therefore the Government is strengthening its value for money test so that the public authorities must rigorously prove the case for including soft services in PFI projects.

Research showed that there was significant variation in the nature, and public sector understanding, of the soft service benchmarking reviews required in some PFI contracts. In future, where the public sector decides to include soft services, the Government will amend the standard PFI contract so that the soft services elements have greater flexibility. This will be achieved by requiring the provision of soft services to be actively competed and market tested at appropriate points during the PFI contract. This will ensure transparency and competition at the point service requirements are reassessed and re-priced. Improving the guidance and support to public sector managers will be a key priority of the PFI Operational Taskforce.

Continuing to Improve the Procurement of PFI

A number of measures have previously been introduced to improve the Government's ability to procure PFI projects successfully, recognising that procurement skills were at a particular premium in PFI procurement. Evidence on PFI projects suggests that procurement times are still long, taking on average over two years from advertising in the Official Journal of the European Union (OJEU) to financial close. Although it is too early to analyse definitively the effect of earlier reforms on procurement times, there is initial evidence that the reforms have had some impact in increasing the

number of projects that close in less than two years. Initial evidence also suggests that approaches such as NHS LIFT can have a significant impact in shortening procurement times.

The Government needs to ensure that the public sector has people with the appropriate skills and experience to develop and manage all procurement projects including PFI projects. These include:

- Developing a secondment model within the public sector so that public servants with experience of complex procurements can be retained and deployed on projects across the public sector;
- Requiring procuring authorities to publish affordability limits that they have confirmed are sufficient to meet their requirement. This should assist in shortening the time taken from the OJEU advertisement to financial close;
- Taking steps to ensure that Private Finance Units (i.e. the Ministry based PFI units) are appropriately resourced to manage their PFI programmes; and
- Developing individual and team procurement skills through formal qualification training.

The Government will also improve the way it monitors projects, building on the lessons learnt from the inter-ministerial Project Review Group, including changing the points at which approval is required so that they better match the key stages of a procurement. This change will help the Government ensure that both central and local government projects are commercially deliverable before engaging the market.

The Government is also considering whether certain measures introduced into PFI procurement can be applied across other forms of conventional procurement. These measures include:

- Extending the use of standardised contracts that articulate a defined risk transfer between the public and private sector;
- Greater use of programme procurement vehicles where there is a sustained programme of investment required; and
- Improving the support structures available to public sector procurers.

Private Finance

Since “PFI: Meeting the Investment Challenge” was published, the market for private finance has continued to develop and debt financing terms have improved. The involvement of private finance is vital to ensuring that assets are delivered on time and on budget and that the procuring authority’s requirement is met through the life the contract.

To support measures to improve the value for money of PFI, the Government will make a number of minor changes to the role that private finance plays in PFI. These steps include:

- Measures to improve the flexibility on termination of bond-funded PFI projects and amendments to its approach to Authority Voluntary Termination; and
- HM Treasury guidance for procuring authorities highlighting the different characteristics of the bank and bond markets and how these characteristics may affect them.

To ensure that private finance supports the lessons and measures introduced on the operational flexibility of PFI projects, further guidance on assessing the impact of the financial structure of PFI projects has been provided in a version of the “Value for Money Assessment Guidance”.

To improve further the transparency of private finance within PFI projects, the Treasury will require debt funding competitions (post the selection of preferred bidder) across all PFI procurements, except where the procuring authority believes that such an approach will unduly increase procurement costs and lengthen procurement times.

The UK Government wishes to ensure that funding markets continue to deliver optimum value for money, recognising the trade-off between price and risk transfer. Such measures can include monitoring the use of equity funding competitions and Credit Guarantee Finance and considering alternative ways of optimising the risk and return of senior debt within PFI projects.

The development of a PFI programme involves continuing evolution and improvement as experience is gained, markets develop and new areas for public sector service delivery are explored. PFI has been successful in delivering high quality facilities for public services, with the benefit of on time and on budget delivery in key sectors of public investment. PFI will therefore continue to be used where it is expected to deliver value for money. HM Treasury's recent publication 'Transforming government procurement', published last month, further reasserts this drive continually to improve procurement and sets out the Government's wider vision on procurement overall.

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Partnerships UK - February 2007

Source: This paper has been largely based on "PFI: Strengthening Long Term Partnerships", HM Treasury, Crown copyright.