

THE CURRENT PERSPECTIVE OF MAJOR UNITED KINGDOM CONSTRUCTION COMPANIES ON THE PRIVATE FINANCE INITIATIVE

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Much of the material published which is devoted to the Private Finance Initiative (PFI) has concentrated on the perceived inadequacies of the PFI. However, notwithstanding its perceived inadequacies, PFI will exert an increasing impact on the United Kingdom construction industry. In consequence, instead of focusing energies into highlighting the problems of the PFI process, all energies must now be directed into the improvement of the process. Both private and public sectors must perform their respective partnership roles effectively in order to ensure the success of the PFI strategy. The paper reports on the outcomes of research completed during the first quarter of 1997, undertaken amongst fourteen major United Kingdom construction companies (identified from the 1996 *Building* ' Top 300 European Contractors ') in order to establish the current perspective of major United Kingdom construction companies on the Private Finance Initiative. On the basis of the findings, recommendations for enhancement of the performance of the PFI initiative in relation to construction projects are proposed and evaluated. The purpose of the research project is to make a significant contribution to facilitating the operational efficiency of the PFI strategy.

Keywords: Construction companies; enhancement, private finance initiative.

INTRODUCTION

The adoption of a private financial base as the vehicle to fund the development of major public construction projects was common in nineteenth century Europe and North America. However, as the influence of central and local government grew through the twentieth century, public funding became the predominant, and eventually monopolistic, basis for the funding of nearly all public construction projects.

Major changes in the politico-economic climate of Europe during the nineteen eighties (Bueker, 1988) have resulted in an increasing inability and unwillingness of governments to fund large-scale public construction projects. Instead, government - led development concessions have reappeared as a politically acceptable funding vehicle for the development of major public construction projects (Tiong, 1990). In the United Kingdom, the necessity to constrain central government's Public Sector Borrowing Requirement has resulted in the introduction of the development concession in the form of the Private Finance Initiative (PFI) strategy.

RESEARCH OBJECTIVES

PFI has succeeded much more readily in some sectors of economic activity than in others. Experience gained thus far in the context of the construction industry is that the success of PFI has been patchy, with some significant successes recorded, set

against a number of disastrous failures (Knowles, 1996). The objectives of the research were to :

- Identify a caucus of parties involved in construction-related PFI projects and, using the experience gained thus far by the members of the caucus :
- Establish the perceived reasons for incidence of under performance
- Propose and evaluate strategies for enhancement.

In order to gain the co-operation of participating industrial partners in the proposed research project, heavy emphasis was placed on the positive, proactive intent underlying the research.

THE PRIVATE FINANCE INITIATIVE

Since the return of a Conservative-led government in 1979, a series of initiatives have been introduced by various government departments in an attempt to transfer the responsibility for the delivery of non-core government goods and services away from the public sector and into the private sector. Examples of this continuing strategy are the introduction of Market Testing by Compulsory Competitive Tendering and, the creation of the Next Steps Agency. The common characteristic of these initiatives is that both control and risk remain within the public sector domain. The Private Finance Initiative is a significant departure from that philosophy, in that the entire control and the greater part of any risk inherent in the project, are to pass into the domain of the private sector developers (Her Majesty's Treasury, 1993 (b)).

The significance of the innovation of the Private Finance Initiative was emphasised by the (then) Chancellor of the Exchequer, the Rt. Hon Kenneth Clarke, (1993) ".....private finance (is at) the heart of all decision-making in government....." It is now recognised throughout the United Kingdom construction industry that for any organisation which seeks to be involved in provision of goods and services funded for purchase by central government, involvement in the PFI process is mandatory.

Her Majesty's Treasury has provided the locus of PFI developmental work. From the outset, it has been made clear to the private economic sector that the Treasury does not intend to formulate a fixed or rigid definition of a PFI project. However, there are specifically defined generic requirements by which a PFI project can be validated (Her Majesty's Treasury, 1993(a)). The two fundamental criteria identified are :

- For any public sector expenditure, value for money must be demonstrated
- All risks inherent in the proposed project must be properly apportioned

There is a symbiotic relationship between these two criteria. The transfer of risk from the public to the private sector is one significant technique in ensuring that the public sector achieves value for money. In principle, value for money is enhanced as risk is transferred. An optimum point is achieved at which all risks inherent in a proposed project are allocated to the development partner best able to manage the relevant risk. Any further transfer of risk will result in a diminution in value for money. Value for money is tested by investigating optional mechanisms of providing the same goods and services within a similar time scale.

PFI projects can be classified according to their method of procurement ; type of facility ; location of facility and, the arrangements adopted relating to funding and

revenue generation . There are basically three generic types of PFI schemes relevant to construction projects (Royal Institution of Chartered Surveyors, 1995) :

Financially Free-Standing Projects : The private sector undertakes the project on the basis that costs will be recovered entirely through charges for services purchased by the final (usually private sector) user. Public sector involvement is limited to facilitating the development of the project, for example, by undertaking some of the initial planning, licensing, awarding works concessions, providing ancillary works or assisting with statutory procedures. Examples of such projects include the River Severn second crossing.

Services Sold to the Public Sector : The cost of the project is met wholly or mainly by the charges made by the private sector body which fulfils the contract. Examples include privately financed prisons and Northern Line trains where the bulk of the payments by the private sector to the lessor are for the use of the capital asset rather than buying associated services. However, finance leases will not be PFI projects. The PFI is expected to lead to more private sector involvement in the operation of assets, since many of the value for money gains in PFI projects come from the benefits of combining asset design, construction and operation.

Joint Ventures : The cost of the project is met partly from public funds and partly from other sources of income, with overall control of the project resting with the private sector. Often the public sector contribution is made to secure wider social benefits that cannot be captured in commercial revenue, such as reduced road congestion. Examples of joint ventures include the Croydon Tramlink.

RESEARCH STRATEGY

The basic philosophy of this research project was ultimately to produce a report which would comprise a series of well-founded recommendations which, if adopted and implemented, would enhance the performance of the PFI initiative in relation to construction projects. The focus on construction projects immediately identified the domain in which the research would be undertaken. In order to ensure that ultimate recommendations were to be *well founded*, two criteria were identified :

- significant level of experience in the operational implementation of PFI ; and,
- high levels of participation in the research project from the identified sample.

During the third quarter of 1996, a range of representatives, taken from identified possible sample groups, were contacted. Informal approaches were made to investigate their preparedness to co-operate in the research project. Whilst the representatives interviewed expressed their interest in the research project and, more especially, its ultimate recommendations, only one group was capable of fulfilling- and prepared to fulfil- the research criteria : major United Kingdom construction companies. In consequence, the research project may be considered to be resource-led. However, there are sound *a priori* grounds for proposing that major construction companies are the principal source of ordinal data on the operation of the PFI strategy (Financial Times,1996).

A preliminary approach was made during the last quarter of 1996 to the largest twenty-five United Kingdom construction companies identified from the 1996 *Building* ' Top 300 European Contractors.' An outline of the research objectives, proposals and methodology, was provided. It was emphasised that the principal philosophy upon which the research is based is to propose and evaluate strategies for

the success of PFI in a construction context, rather than to replicate reports on the perceived inadequacies of PFI. Eighteen companies responded, and sixteen expressed their willingness to co-operate in the research project. This group formed the original caucus on which the first stage of the research project was based, commencing in January 1997.

On the basis of *a priori* experience, the research project was to comprise a Delphi group-based development programme, conducted via a combination of questionnaires and action research. An iterative Delphi-style process was to be adopted to facilitate data collection and consensus formation. The rationale underlying this approach was to identify extreme polarities of opinion by correlation. A rating and ranking matrix structure was adopted in the questionnaire format, and a sequence was adopted which attempted to remove primacy and recency effects, also randomness. Validation of questionnaire returns is claimed on the basis of a Kendall's Tau co-efficient. Variances were identified and evaluated by applying Mann-Witney U-Wilcoxon Rank Sum W tests. Finally a t-test was applied to establish confidence limits, allowing for probable variation in uncertainty, thus ameliorating any possible effects of the presence of Millikan's Error. The validation process was exercised within the population group ; sample / sample.

The research programme was subsequently developed further by undertaking structured interviews with seven of the contributing companies who had expressed a willingness for additional involvement. The process continued until it became apparent that saturation point had been reached.

PERCEIVED REASONS FOR UNDER PERFORMANCE

The first stage of the research process involved the preparation and distribution of a questionnaire to the sixteen co-operating contracting organisations. Completed questionnaire responses were received from all sixteen participating contractors. However, two of the responses were drafted in a manner which would have clearly identified the relevant companies as respondents. After discussion with the two companies, it was agreed that they would not proceed further with any involvement in the research project. This reduced the caucus on which the questionnaire responses were based to fourteen companies. The outcomes were summarised and agreed with all of the participating companies. Impartial validation of the findings was sought by identifying recently-published PFI-related material commenting on each of the findings. This exercise, incidentally, involved reading nearly eight hundred separate articles.

During the summarisation process, it became apparent that the perceived reasons for under performance as reported in the questionnaires could be allocated into three categories :

- Systems
- Funding
- Personnel

However, the demarcations between these allocations are far from clear or rigid. In particular, the demarcation between Systems and the remaining two categories of Funding and Personnel are understandably imprecise. Further, it proved unfeasible to establish a consensus of opinion on the rank significance of the findings. The

following represents an outline summary of the perceived principal reasons for incidence of under performance of PFI construction-related projects

Systems

1. The organisational structures and characteristics of public sector purchasers may be incompatible with integration with commercial companies (Royal Institute of British Architects Journal, 1997) .
2. Public sector purchasers are perceived as unnecessarily defensive and secretive, appearing to operate on a 'knowledge is power' principle which is tending to create a commercial caste system (Barrie, 1995).
3. Excessive bureaucratic proceduralism resulting in high bidding costs (Matheou, 1996).
4. Inadequately developed purchaser's brief, allied to an unwillingness to take assistance and advice from involved bidders (Barrie, 1996(b)).
5. Risk allocation and its relationship to levels of expected financial return remains a highly contentious issue. One of the foundational principles of the PFI strategy is that risk is allocated to whoever is best suited to its management, not that risk may be transferred in order to avoid responsibility and accountability (Davis Langdon & Everest, 1996 ; Slavid, 1997).
6. High tendering costs, especially as most public sector purchasers adopt two-stage tendering, and retaining tenderers within the procurement process for a period which would be regarded as unacceptably protracted in most commercial environments (Chevin, 1996).
7. Public sector purchasers place strong emphasis on the innovatory capabilities of bidders. However, innovative proposals submitted by any one bidder are deemed unacceptable, in case acceptance is perceived as purchaser bias towards the involved bidder (Ball, 1996).

Funding

1. The refusal of Her Majesty's Treasury to guarantee long-term funding to public sector purchasers has created an atmosphere of uncertainty in which it is not possible to procure commercially-based funding (Latham, 1996).
2. For many large-scale infrastructure projects, the estimated revenue stream is insufficient to ensure the project's fiscal feasibility. There exists a reticence on the part of Her Majesty's Treasury to accept the significance of social benefit in evaluating such projects (Baillieu and Doyle, 1995).
3. The equity levels frequently demanded by public sector purchasers of PFI bidding consortia members cannot be achieved by many construction companies, recognising the relative weakness in the balance sheets of most construction companies. In the first half of 1995, the ten largest construction companies operating in the United Kingdom made total operating profits of seven million pounds from total received revenues of £4.5bn (Harding, 1996).

Personnel

1. Many public sector purchasers involved in the PFI process have yet to make the cultural transition from a compliance to an innovative, entrepreneurial operating environment (Sherman, 1996).

2. Many public sector purchasers' staff are alleged to be unreliable and inconsistent as business partners (Doyle, 1996).
3. A bland refusal to comply with PFI regulatory procedures (Janes, 1996).
4. Many public sector purchasers involved in the PFI process have not yet acquired the level of skill and expertise necessary to implement PFI successfully (Barrie, 1996(a)).
5. The incorporation of value for money testing into the appraisal process for PFI bids can be distorted by public sector purchasers into demands that bids are lower than those which would emanate from traditional procurement routes (Phillips, 1996).
6. Delays in the development of PFI construction projects are endemic. However, purchaser insist that imperative dates are immutable. Contractors allege that this is a tactic adopted by public sector purchasers to avoid decision-making (Knowles, 1996).
7. Over-specification, particularly in secondary areas of project significance, apparently in pursuit of reassurance based on bounded rationality (Ball, 1996).
8. Many public service staff members of the Public Finance Panel Executive are appointed for extremely short periods. This appears to have the consequence of discouraging staff from any sense of ownership of the PFI strategy which they are responsible for facilitating (Knowles, 1996).

STRATEGIES FOR ENHANCEMENT

This stage of the research programme was undertaken by adopting a more formalised Delphi group-based development programme involving all fourteen questionnaire respondent companies. The Delphi process was strengthened further by pursuing a combined programme of structured interviews and action research (Lewin, 1946 ; Gill, 1986 ; Jorgensen, 1989). This latter part of the research programme was conducted with seven of the 14 Delphi group participating companies. Interviews were undertaken during March and April 1997, and continued until it became apparent that saturation point had been reached.

The recommendations identified for enhancement of the operation of the PFI strategy are allocated into the three categories adopted previously :

Systems

1. At *Invitation to Negotiate Stage*, the quality of the proposal is critical. Accounting Officers should apply a high level of integrity and expertise in the scrutiny of preliminary proposals. The procedures adopted and the outcomes established should be transparent and made available to candidate companies for the bid list.
2. Accounting Officers should be charged with the obligation to demonstrate, as part of a public accountability requirement, that procedures possessing high integrity are established to undertake business critical operations such as : outline business case; payment mechanisms; capital and operating expenditure ; risk transfer ; procurement procedure ; award timetable ; planning requirements and, asset disposal.
3. Reimbursement of bidding costs is a matter which should be addressed rather than dismissed. Exceptional bidding costs ; bidding costs incurred after *Invitation to*

Negotiate Stage for a project aborted by the public sector purchaser for reasons not involving the bidders ; contingency bidding to reimburse, at least in part, underbidders. All are issues which should and could be addressed.

4. Companies not selected for the bid list, together with all unsuccessful tenderers, to be debriefed as a matter of policy, in order to ensure that all involved parties learn positively from the experience.
5. The preferred bidder should be selected and appointed as early as possible in the bidding process in order that for all involved parties, uncertainties and cost burdens are minimised. This would also give the involved parties the liberty to freely introduce, evaluate and adopt innovatory proposals.
6. The public purchaser's specification should be drafted exclusively in terms of output requirements. This would enable the bidders to achieve entrepreneurial manoeuvrability on the basis of added value generators such as private sector partnership and, residual value enhancement.
7. The apportionment of risk inherent in any proposed PFI project should be undertaken on a mutually-agreed, transparent and cogent basis : Systematic or procedural risk should be accepted by the public purchaser. Trading risk and demand risk (also termed ' volume risk / usage risk / revenue risk ') should be shared on a negotiated basis. Negotiations should include consideration of provision of protection for the private sector supplier against exceptional demand risks which could not reasonably have been foreseen. In some instances, it is accepted that it may be necessary to require bidders to bid against specifications which respectively include and exclude the transfer of demand risk, as a form of value for money analysis. However, where the public sector is not the end user of the completed project, the imposition of any demand risk on the private sector supplier is unjustified.

PFI projects frequently involve the assessment of a combination of revenue returns over a protracted operating continuum with financing mechanisms over a relatively short term period. Contract-led projects produce assured revenue return at an early stage in the development of the project, since the public purchaser can enter offtake contracts with the end user of the completed project. Market-led projects depend on revenue return forecasts, which are functions of a matrix of changeable variables. These factors should be central to the negotiating strategy undertaken between the public purchaser and bidders.

Funding

1. The Private Finance Panel should produce a quarterly ranking of the priority of proposed PFI projects, together with a commitment from Her Majesty's Treasury of minimum public funding to each project identified. In every case, this reportage system would apply to proposed projects prior to their respective Invitation to Negotiate Stage.
2. The Private Finance Panel should be uncoupled from Her Majesty's Treasury and awarded independent status. The Panel should then become an impartial broker responsible and accountable for the brokerage of proposed PFI projects.
3. Her Majesty's Treasury can convert a financially marginal proposed PFI project into a viable project by accepting a reasonable quantum of the cost of the risk inherent in the project. This would enhance credit ratings of contractors and assist

in persuading commercial lending institutions to greater involvement in underwriting PFI-related activities. The techniques adopted in managing the difficulties inherent in identifying, simulating and evaluating risks should be cogent and transparent, rather than post-hoc justification exercises as alleged by some bidders. Thus the limitations of sensitivity analysis when applied to valuation of only one significant variable should be acknowledged. More sophisticated funding decision-making tools should be adopted, such as Monte Carlo simulation to evaluate the overall effects of change on a matrix of variables.

Personnel

1. A cogent strategy of knowledge dissemination and skill training is urgently required in order to ensure consistency and propriety of performance. The current public service PFI training programme is inadequate in terms of time scale, extent and content. In view of the skills demanded by the PFI strategy, it is believed justifiable that the public servants involved should qualify for performance-related reward schemes.
2. Accounting Officers should encourage staff to co-operate with industrialists, and seek advice and guidance in commercial skills acquisition, without any stigma of an admission of failure being attached to such an open management approach to proposed PFI projects.
3. The procedures and decision-making of public servants responsible for procuring PFI projects should be subject to more detailed public accountability than is the case at present. The object of this proposal is to ensure greater compliance with authorised guidelines than is currently the case.
4. The Private Finance Panel Executive should appoint public service staff members on a more permanent basis than is the case at present. It is important that staff regard such an appointment as career advancement, and develop a sense of ownership of- and responsibility for- the PFI strategy.

CONCLUSIONS

On the basis of the research project undertaken with fourteen major United Kingdom construction companies, a number of significant proposals for enhancement of the PFI strategy have been identified. There is a clear recognition amongst the contractors surveyed that

- the PFI strategy is now a permanent feature of the construction industry's provision of goods and services to the United Kingdom economy
- the PFI strategy must be made to work efficiently in the interests of the construction industry and the national economy.

A further outcome of the research project is the strong support amongst the contractors surveyed for the concept of the PFI strategy. Despite the perceived problems encountered during the introduction of the PFI strategy, the attitude amongst the contractors' personnel interviewed could perhaps best be summarised by paraphrasing Beatrice Webb : "I've seen the future, and it can be made to work."

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