PFI POLICY SINCE 1996 AND THE IMPLICATIONS FOR SMALL AND MEDIUM SIZED ENTERPRISES IN THE UK CONSTRUCTION INDUSTRY

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Since 1996 and despite initial problems, the UK labour Government has continued to support the PFI as one of the main mechanisms through which public sector provision can be achieved in partnership with the private sector. The Bates Report recommended the establishment of a Treasury Taskforce to become the main source of information and guidance for all PFI activities and addressed the problem of high bidding costs incurred by the private sector. Indications are that, despite continuing problems, there is a slow growth in private investment in public sector projects with an accompanying decrease in public investment, since 1996.

PFI policies since 1996 are examined and reveal that there is no evidence that they allow increased participation in PFI for UK Small and Medium Enterprises (SMEs) in the UK construction industry. The major share of PFI project values, 94%, fall within cost ranges of +£10 million, a factor which restricts participation of SMEs. At a time when both the UK government and the European Community is actively promoting the competitiveness and participation of SMEs, there is no evidence of a distinctive coherent strategy to encourage SMEs to bid for PFI projects whose inherent risks and requirements for expertise, make them suitable only for larger contracting organizations. The paper is a qualitative study which reviews and critically analyses policy documentation and data and commentary from learned papers and journals.

Keywords: competition, private finance initiative, SMEs, value for money.

INTRODUCTION

The trials of the PFI since 1992 have been well documented (McLellan 1994, Middleboe 1994, Knowles 1996, Lovell, White and Durrant 1996, Hodgson and Davies 1997, Owen and Merna 1997, Ezulike, Perry and Hawwash 1997, Akintoye, Taylor and Fitzgerald 1998, Birnie 1998). Running in parallel a series of guidelines, consultation papers, reports and press releases have been published by the government department responsible for the PFI i.e. the Department of the Environment, Transport and the Regions (DETR, formerly DOE). These series of official publications, some of which implement the findings of the Bates (1997) Review, are the demonstration of government concern over the problems faced by the private sector in bidding for public sector services. (DETR 1999a)

The main criticisms of PFI include high and abortive bidding costs, inappropriate detail in client briefs, inexperience of civil servants and lack of genuine transfer of risk/reward to the private sector (Greenhalgh 1996). In reviewing the early problems encountered, Birnie (1998) focuses on risk as the main outstanding problem for bidders, other drawbacks such as high tendering costs and bureaucracy having already been addressed by the government in the Bates (1997) Review, an outline of which is set out in the following sections.

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The problems of PFI have focused primarily on the participating private sector companies which normally include major contracting and consulting organizations. Ezulike *et al.* (1997), however, have examined in some detail the barriers to particip-ation of smaller organizations and after interviewing SME and large contractors, found that high participation costs deterred all groups. As an example one interviewee quoted £500,000 as expenditure on participation in one PFI project compared with £100,000 for five conventional bids although high expenditure in PFI was matched by high returns. Five further major barriers of entry include high project values, high risk, lack of credibility and contacts, demands on management time and lack of appropriate skills Whole life costing, project management structures, relationship building, risk assessment and allocation are skills which small to medium sized contractors may not possess. Unless contractors adapt to the PFI there will be no major publicly funded infrastructure or housing projects to replace it. Obviously it is easier for larger companies to participate than smaller ones especially since the project values tend to be high. For larger value projects capital and financial requirements together with technical and managerial needs are more easily supplied by larger companies of which there are only a few, compared to the much greater number of smaller companies. (Hillebrandt 1984, Ball 1988, Male 1991)

Birnie (1998) cites the Knowles Report (1996) which recommends that PFI is used for much larger projects. The scale of projects bid for by companies such as Laing, who have established a minimum value of £20m, is obviously a deterrent to smaller contracting organizations. The growth of management contracting and joint venture procurement systems with financial institutions, facilities management consultancies and investment fund managers collaborating as partners, is likely to assist the involvement of smaller firms.

The problems of bidding for PFI projects are currently being addressed by the government following the Bates Review, with a further review to be conducted prior to the expiry of the Taskforce's mandate in the summer of 1999. (DETR 1998a). Essentially the new review will address the progress that has been made in implementing the recommendations of the first review and the effectiveness of the Taskforce. According to Barrie (1999: 22–27) Government support for the scheme continues to flourish and, to a certain extent, major companies have benefited from PFI investment. White (1999) reports a 116% rise in pre-tax profit for McAlpine which has been largely the result of successful bidding for major PFI projects in 1998.

In the context of these developments the aim of this paper is to review the progress of PFI since 1996, with particular attention focused on government and European policy relating to SMEs and public procurement. Figures showing the development of public and private investment in PFI projects will be analysed to assess whether SMEs are being allowed access to this potentially lucrative, if complex, market.

THE BATES REVIEW

Bates (1997), after consultation with over 200 organizations, has proposed institutional changes and made a series of recommendations including a number requiring specific action within a published time scale. The recommendations of the review fall into four categories.

1–7 Institutional Structure - establishing the Treasury Taskforce and the commercial viability of all significant projects prior to the procurement process, thus reducing abortive bidding costs

8–23 Improving the process - including the need to standardize procedures for obtaining information from prospective tenderers and the compilation of model tender documents and contract conditions in order to reduce negotiation periods with preferred bidders.

24-28 Learning lessons - including training of public sector personnel in project management, project finance and negotiating skills. General guidance and specific guidance to be offered on the way the public sector evaluates value for money through Public Sector Comparators (PSCs)

29 - Bid costs - includes the minimization of costs to the private sector when submitting a bid for PFI projects and where a project is considered not viable for reasons other than the tender return, contractors' bidding costs should be refunded. The proposed maximum number of bidders is four.

Following acceptance of the recommendations an introductory guide entitled 'Partnerships for Prosperity' was launched in November 1997 setting out the terms of government support, the role of the new Treasury Private Finance Taskforce, fundamental policy principles, the procurement process and lists of key contacts and references. A later document 'Public/Private Partnerships and the Private Finance Initiative' (DETR 1999b) refers to the role of the DETR as procurer of a wide range of PPP/PFI projects and reiterates the importance of PFI, citing it as providing 'excellent value for money'. PPPs are seen to be of special importance in the field of education. The paper outlines support for local authority projects to be streamlined and strengthened under a new framework and refers to measures to develop Design Build Finance Operate procedures for a full range of local services and the introduction of the Local Government (Contracts) Act to allow local authorities the power of entering into PFI contracts.

Apart from the transfer of risk to the private sector, a fundamental requirement of PFI is achievement of value for money (VFM). The fundamental purpose of VFM is to decide whether a project will proceed and, in doing so, addresses recommendation 4 of the Bates Review which seeks to sign off the commercial viability of projects before the start of the procurement process by costing Reference Projects as part of a Public Sector Comparator (PSCs) (Refer to DETR 1999c). A press release (DETR 1998b) refers to this recommendation and the need to 'road test ... all significant projects' before major procurement costs are incurred, 'significant' being defined as 'big, high profile, highly replicable or ground breaking'.

THE DEVELOPMENT OF PFI FROM 1996

In March 1998 the Taskforce published figures showing the cost saving benefits of PFI compared with traditional routes. (DETR 1998c) This and other press releases from the Treasury Taskforce Private Finance Projects Team, dating from the appointment of Bates for the first review in June 1997 to June 1999, are very positive in their declarations of the ongoing success of PFI.

Notwithstanding the DETR's determination to be optimistic, in spite of the prolific and complex problems outlined above, there are indications that Private Finance procurement is growing at the expense of conventional public procurement, albeit at a slow rate. The DETR's Annual Report (1998) refers to the growth of private investment in public sector projects since 1988 with £13 billion invested in social housing and £15 billion invested since 1990 to support regeneration schemes. The transport sector accounts for most private investment to date with major infrastructure

Table 1: Development of public investment in PFI projects*

Projects involving PFI (excludes LA projects)	**1996-97 estimated outturn**	**1997-98 estimated outturn**	**1998-99 projected outturn**	**1999-00 projected outturn**
Capital spending by private sector £m	285	360	435	775
Capital spending by public sector £m	4182	5503	5172	5256
Estimated gross public spending £m	4467	5863	5607	6040
Net current payments by public sector £m	15	10	170	320

* Source: DETR Annual Report (1999) Appendix C (1998 AR for 1996-97 figures)

projects attracting over £3 billion since 1995. Table 1 shows the estimated and forecasted development of investment and expenditure on PFI projects, excluding local authority schemes and compares it with public sector spending under conventional procurement. (DETR Annual Report 1999).

It is interesting to note that the DETR Annual Report (1998) shows projected capital spending on PFI projects to be £765m in 1997-98 and £796m in 1998-99 with a parallel decrease in public sector spending. These higher figures for PFI would seem to underline the optimism with which the DETR views future development and means that the projected out-turns shown in Table 1 should be treated with some caution.

Figure 1 compares the percentage difference in capital spending between the public and private sector, taking 1996-97 as the base with an index of 0. The percentage increase for 1997-98 shows similar growth for 1997-98 estimated out-turn (33% private, 32% public) with the gap widening for projections in 1998-99 (29% difference) and 1999-00 (146% difference). Public investment is seen to diminish from one third to approximately one quarter of its base 1996-97 level whereas private investment increases by more than half in 1998-99 with a projected increase in 1999-00 of 172%. It remains to be seen whether public investment will continue to decrease to its 1996-97 level or whether the optimistic projections for 2000 are eventually achieved.

Figure 2 compares the contribution in capital spending by public and private sectors to estimated gross public spending from 1996 to 2000. Percentages remain static for both sectors in 1996-97 and 1997-98. A small movement upwards to 13% for the private sector is matched by a similar movement downwards for public investment. At 1999-00 there is a projected gap of 74% indicating that the progress of private investment in PFI is slow and still requires extensive movement if the public spending commitment is to be further reduced. Denny (1999) indicates that private sector investment in PFI will account for 14% of overall public sector investment by the end of 1999. This percentage forecast involves schemes which may not be relevant to the construction industry.

SMALL AND MEDIUM SIZE ENTERPRISES

UK SMEs and restrictions on participation in the PFI

The Department of Trade and Industry (DTI) publishes statistics showing the SMEs' share of businesses, employment and turnover for major industry sectors. The 1997 figures for the UK construction industry are shown in Table 2 (DTI 1998).

The figures show that SMEs form a substantial component of construction with more than 99.9% companies falling into this category and taking an 87.2% share of employment and 75.2 share of turnover. The current definitions of SMEs by the DTI

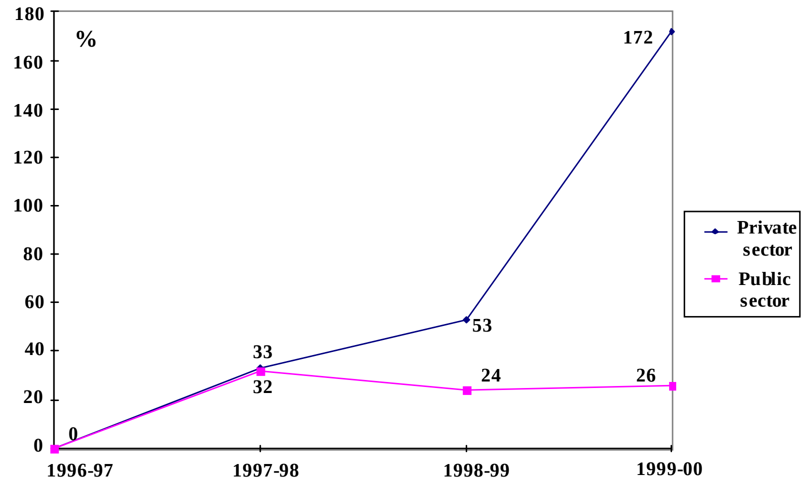

Figure 1: Comparison of growth in capital spending by public and private sectors on PFI projects (1996-97 base = 0)

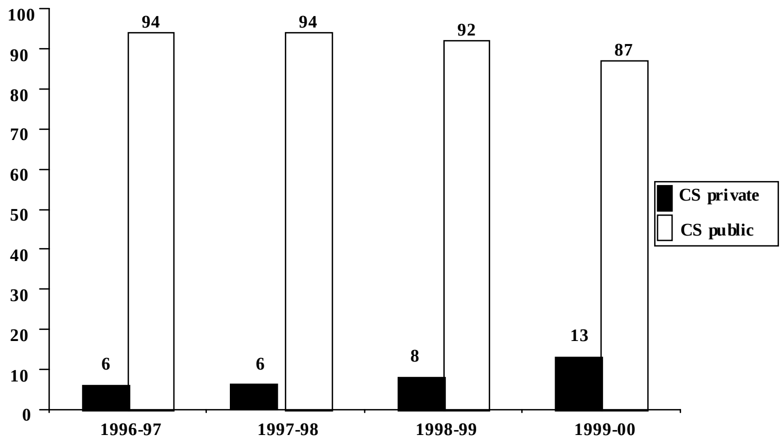

Figure 2: Comparison of capital spending as percentage of gross public spending by public and private sectors (1996-98 estimated, 1998-00 projected)

Table 2: SME share of businesses, employment and turnover by industry 1997*

SME Share	Businesses	Employment			Turnover
	Total No	SME % Share	Total No	SME % Share	SME % Share
Construction	829,000	100	1587	87.2	75.2

* Source : DTI SME Statistics Unit

and the European Commission are businesses with less than 250 employees and maximum annual turnover of 40 million ECU's (approximately £30-35 million). (DTI 1997). SME contribution to the construction industry economy is of the utmost importance, and, because of this, should be considered as of primary significance in the potential contribution to PFI.

The development, design and construction of roads, transport, housing etc. are obvious functions of the construction industry whereas the finance and operation of PFI projects can require specialisms skills not yet developed. Participation in the bidding process can be costly for SMEs. When putting together a consortium to design, finance, build, operate, maintain, manage, there are few companies that have all these specialisms and the employment of external consultants makes the tendering process expensive. Estimates put the cost of tendering at over six times greater than other procurement methods in some cases. (Birnie 1998).

Restrictions on public sector participation in European procurement

Bovis (1998) states that SME public sector participation in Europe accounts for 2.2% of the EU's GDP (approximately 94 billion ECU). 'This is translated to 15.3% of the share of the total participation of enterprises in public procurement'. Despite their major representation of businesses in Europe the share in public markets is limited. Bovis maintains that SMEs are inhibited from tendering for public projects because of the large size of projects, the difficulty in obtaining bidding information, poor language skills, time and costs of bidding, scarce resources, difficulties relating to norms, certification, quality assurance and company credibility and delays in payments. The solution to improvement in SME participation could lie in preference schemes but these have been abolished when the UK joined the EU and 'are deemed to contravene directly or indirectly the basic principle of non-discrimination on grounds of nationality...' Bovis proposes a number of strategies to allow SME participation:

- creation of certain thresholds in public procurement directives which will allow access to a certain percentage of public contracts.
- provisions to oblige bidders to divide a certain percentage of contracts into sub-contract packages.
- preference in favour of SMEs in certain areas through price advantage or government subsidies.

Unfortunately, as acknowledged by Bovis, these suggestions are difficult to implement as they may be incompatible with EC law. (Bovis 1998)

The importance of SMEs as providers of two-thirds of employment in Europe has been recognized in the EC Fifth Framework programme for 1998-2002. The aim of this research programme is to increase the socio-economic impact of European research through concentration of its effects on competition and employment. The strategy includes the promotion of international co-operation, the unlocking of scientific and technical potential and the innovation and participation of SMEs who 'must be given easy access to available technologies' through incentive measures of support and funding. (European Commission 1997).

In 1997 the European Union Small and Medium Sized Enterprise (SME) Initiative was introduced in England. The aims are to provide English SMEs with grants and guidance support to help them increase export potential and to become more competitive in the European market. Support includes funding for the following:

- design and implementation of business strategies
- co-operation and networking between SMEs in the EU
- participation and tendering for international public procurement contracts
- training aimed at helping SMEs to export more effectively including overseas secondment of staff

The European commitment to SMEs is reiterated in contemporary government strategies. A document published by the DETR (1997), 'Building Partnerships for Posterity', refers to the creation of Business Links, 89 partnerships designed to offer support and guidance to SMEs in order to help them develop in internationally competitive markets. Business Links include Chambers of Commerce, Training and

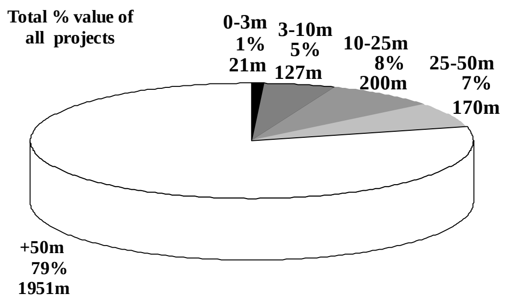

Figure 3: Total percentage value of all projects in categories of £m

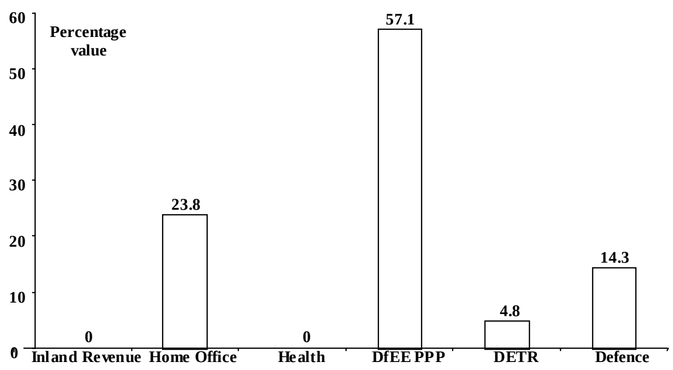

Figure 4: Distribution of PFI projects in £0-3 million cost range

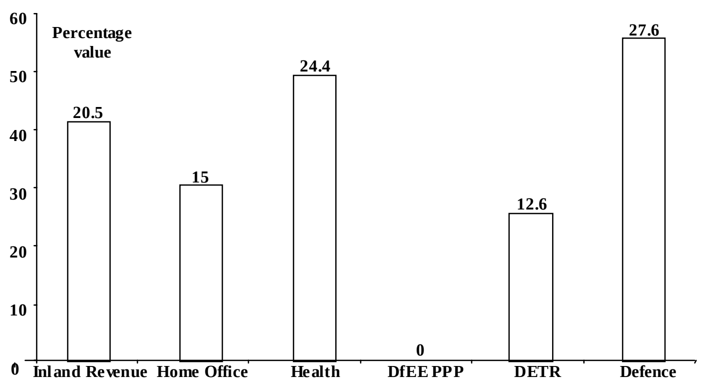

Figure 5: Distribution of PFI projects in £3-10 million cost range

Enterprise Councils, local enterprise agencies and local authorities *i.e.* publicly funded private organizations set up to give SMEs access to the full range of Government services. 'Smart' is another government scheme which provides financial support to SMEs in order to help them develop new products and innovative systems. Chapter 5 of this document outlines business support available and also emphasizes the importance of the PFI 'which transforms public sector bodies from being owners and operators of assets into intelligent purchasers of services from the private sector, where this offers good value.' Firms become long-term providers of services rather than 'up-front constructors of assets' and thus enter into long-term relationships with the public sector. The importance of encouraging the development of SMEs and also the significance of PFI are seen by the DETR to be closely linked.

In 1998 the chancellor's budget announcement confirms the commitment by including plans to encourage SMEs to develop and invest and by stimulating the provision of equity finance for 'smaller, higher-risk trading companies.' (HM Treasury 1998)

Preliminary enquiries made to the PFI Taskforce helplines indicate that, although there are continuing efforts to reduce onerous risk and simplify bidding procedures, there is no specific current strategy to address the special requirements of the SME sector. On the positive side a document published by the DTI, 'Tendering for Government Contracts' for SMEs, includes guidance on bidding for PFI projects and for competing in the European market. (DTI 1998)

Effects of restrictions on UK SMEs

The range of PFI project values as published by the DETR (1998) are translated into an overall percentage for all schemes as shown in Figure 3. This shows quite clearly that the cost range of projects in the less than £3 million pounds bracket is only 1% with a further 5% in the £3-10 million range. The lion's share of PFI work is in the plus £50 million range.

Figures 4 and 5 show the distribution of project values £0-3 and £3-10 million between the six major sectors of construction (DETR 1998d). Figure 4 shows clearly that PFI projects in the £0-3 million pounds range are usually in the education sector (DfEE 57.1%), the Home Office (23.8%) and defence (14.03%). Work in this cost range represents only 1% (£21 million) of the total value of all PFI work (£1951 million). SMEs who bid for smaller scale work may be restricted to bidding for work in these sectors. Larger SMEs may be eligible for projects covered in the £3-10 million range which indicates a much broader distribution throughout all sectors with defence taking 37.6% and health taking 24.4%. Again the of the overall PFI cake is very small being 5% or £127 million in value (see Figure 3).

PFI: SUCCESS OR FAILURE?

Commentaries in trade journals on the progress of PFI since its launch in 1992, are prolific and reflect the persistent controversy surrounding the initiative. Barrie (1999 pp10-11) reports extensively on the crisis in PFI and the government's confirmation of support for the scheme. The coverage, however, does not make specific reference to the plight of SMEs and includes contractors' responses to a survey directed at Britain's 25 biggest contractors. An editorial in Building (1999) sees PFI as reaching a critical stage but, on balance, a force for progress if it provides genuine VFM and both the public sector and private sector support it. Despite recurring contentious news items there is also a steady stream of articles which indicate that major contractors and consultancies are continuing to win PFI bids for multi-million pound deals.

CONCLUSIONS

The fate of the PFI in the UK appears to be hanging in the balance. Since 1992 and despite enormous problems, contractors and consultants have been able to fund, build and operate a range of provision including roads, prisons, hospitals and schools. Capital spending on public schemes by the private sector is slowly eroding public sector spending. Successive governments have sought to address the problems of PFI, the major one being private sector risk, by issuing a series of reviews and guidelines designed to palliate the process and attract bidders. At the same time the government, in the national context and also as a European member state, have confirmed their commitment to the development of SMEs as important contributors to the economy.

Unfortunately large projects make up 94% of PFI opportunities, greatly restricting the opportunities for SMEs to participate in public sector schemes. The problem is compounded by a government recommendation to limit the ‘road-testing’ of commercial viable projects to those of significant size. Besides the size of projects other barriers related to this problem exist and these include lack of appropriate expertise, lack of credibility and high risk. Further restrictions are caused by EC law which does not allow preferential treatment to be awarded to SMEs in the procurement process.

On a more positive note, recent recommendations made by Bates to cut the abortive costs of tendering are now being implemented. The policy of Public Private Partnerships and the extension of PFI procurement to the Local Authority sector means that there are increasing opportunities for SMEs to participate on smaller projects. Figure 4 shows that in the £0-3 million range, projects run by the DfEE PPP schemes may be open to SME participation and figure 5 shows that for larger schemes all sectors apart from DfEE can be targeted.

There are no government figures currently available on the breakdown of company participation in PFI projects. The very large number of SMEs in the UK construction industry comprise many sub-contracting organizations and consultancies who do bid for work sub-let by major companies and also who bid as part of a larger consortium for joint venture schemes. At the moment it is apparent that only major contractors and consultancies can realistically bid for PFI projects as main participators. Although the government acknowledges the importance of issuing guidance to SMEs on tendering for public contracts and on PFI procedures, there is no UK strategy which addresses the problem of restrictive entry and competition for SMEs. The same is true in Europe, where the principle of competition is upheld in parallel with a recognition of the critical importance of SMEs in the single market economy. As we have seen, alleviation of restriction to European SMEs may only be achieved by sacrificing anti-discriminatory regulation in public procurement and by the creation of preferential quotas. Whilst the PFI limits entry to mainly major organizations its future success must always hang in the balance since it ignores the crucial 75% contribution to UK construction turnover made by SMEs and, consequently, the skills and expertise of a highly effective and innovatory sector.

AREAS OF FURTHER RESEARCH

As the PFI continues to develop, more data on capital spending is available. Further research is necessary on the actual participation of SMEs in PFI as main bidders, sub-contractors or joint venturers and the issues which deter them from participation. This will enable the adoption of coherent government led strategies to include SMEs on a more substantial scale and to create legislation if necessary. Other subsidiary areas of research could examine the effectiveness of the PSC in cutting bidding risk and examine its influence on participation by either major or SME organizations.

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