THE PRIVATE FINANCE INITIATIVE: THE PROCUREMENT PROCESS IN PERSPECTIVE

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Since the introduction of the Private Finance Initiative (PFI) in 1992, the UK government has been attempting to procure infrastructure projects through private sector participation by way of public-private partnerships. This piece of work examines the key stages of the procurement process and looks at the extent to which the respective stages of the process up to financial close contribute to the risk burdens that confront the participants and how far the various institutional frameworks and policies have helped in minimizing these risk burdens. Based on evidence from the findings of a survey the research has demonstrated that it is at the tender evaluation and the negotiation stages that the risk burdens are exacerbated most. The conclusion drawn is that though the institutional frameworks and policies have helped to improve the process there is the need for further skills development.

Keywords: Private Finance Initiative, procurement, risk, public private partnership

INTRODUCTION

Historically, the involvement of the private sector in the financing and promotion of national infrastructure is neither a strange nor a new phenomenon. In the early days of the of rails and canals, private landowners or interested parties and contractors promoted their development and began to raise funds for them on speculative basis (Walter and Smith, 1995; Winch, 2000). From the 19th century however the state began to play a greater role as the client of the construction industry where the lowest tender price through open competitive bidding became the basis of assessing value and the choice of contractors. With this came the growth of the professional system seeking to protect the interest of the client. The result of this development as observed by Curtis *et al.* (1989) and Cooney, (1993) and cited in Winch (2000), was that as clients tried to push down their production costs, they saw their transaction costs rising in the form of fees to professionals. This approach has of late been observed as not only acting as a constraint on contractor's ability to innovate but also adversarial and thus contributing to inefficiency and lack of growth in the industry (Latham, 1994; Egan, 1998; Ward, 1998).

The thinking had started changing from the 1960s however towards a search for 'best practice' in construction procurement. This led to the introduction of such innovative procurement strategies as selective rather than open competitive bidding, management contracting, package deals, and design-build. Other strategies included more collaborative and win-win approach to construction procurement in the forms of partnering promoted in the main by the private sector clients (Turner, 1990; Cox and Townsend, 1998). Increasingly, the awareness also began to dawn on the public sector

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which has the largest construction spend to improve efficiency in the procurement of projects and obtain value for money. The outcome of this was the introduction of a number of initiatives one of which is the PFI. Launched in 1992, the policy is aimed at harnessing private sector capital and efficiency gains by allocating risks to the party best able to manage them optimally.

The initiative has been backed by various institutional frameworks, which have undergone two major reviews aimed principally at streamlining the process. The Bates reviews of 1997 and 1999 culminated in the formation of Partnerships UK, a public-private body with the objective of building up £1.0 billion equity and debt funding for the PFI projects (Building, 1999). This paper outlines the basic principles and the processes of PFI project procurement up to financial close and highlights some of the key challenges such as the risk burdens on the contracting parties, and the findings of a survey on these risk burdens during these stages of the procurement process.

THE PRIVATE FINANCE INITIATIVE

Principles and philosophy

A cardinal principle or philosophy behind the PFI is that it is intended to transform government departments from being owners and operators of assets into the purchasers of services from the private sector. The private firms then become long-term providers of services rather than up-front asset builders, by shouldering the responsibility for designing, constructing, financing, and operating the assets in order to deliver the service demanded by the public sector. The project structure is expected to allocate risks to the private sector for efficiency benefits to be generated across the life of the project and also allow the private sector to innovate and design away risks that bring new ideas to the way the service is provided. The project should thus have substantial operating content, a clear boundary and measurable output performance. Paramount to all these is the principle that the risks transferred to the service provider are commercial in nature and controllable (Treasury Taskforce, 1997)

In PFI procurement the public sector rather specifies its services by way of an output specifications. These output specifications cover the objectives, purpose, scope and performance requirements for the contract, with emphasis being on the '***what'*** and not the '***how'*** in relation to the service provision (Private Finance Panel, 1996a). Table 1 provides an overview of the PFI procurement process as opposed to the traditional form.

A distinctive feature of the PFI procurement is the direct linkage of payments to performance and quality. As noted by Williams (1995), the service level of any PFI project agreement can be said to be the 'teeth' of a PFI deal, and therefore the trigger for remedies and the primary tool for withholding payment to the service provider in the event of default.

The procurement process and related risks

The strategic decision phase of the PFI procurement process involves establishing a business need, options appraisal, development of a business case, deriving a public sector comparator. The rest of the process to financial close as outlined in Figure 1 may involve an initial market sounding by holding preliminary discussions with an appropriate sample of construction companies and developers, manufacturers, facility management and service providers, bankers/financiers/insurers, advisers and other equity participants. Issues at this stage might centre around the size and length and structure of the contract, the balance between asset provision and the service delivery, the scope for transfer of risks, and the management of staff and customers who could be affected. Other areas may include the scope of third party revenues and alternative asset uses during the contract life, ownership of the asset at the end of the contract, the ownership of other associated assets such as adjoining parcels of land. This was the case in the Dartford and Gravesham hospital projects where a component of the consortium's financing arrangements were the proceeds of £21.9m generated through the disposal of three surplus land sites. This helped the deal and avoided the need for the consortium, Pentland, to seek more equity finance (National Audit Office, 1999a p 40). However, due care is needed during such market sounding in order t avoid the risk of restricting competition or giving one bidder/supplier an unfair advantage over another.

Table 1: Key differences between traditional public sector procurement and PFI

Area of consideration	**Traditional public sector procurement**	**PFI procurement**
Duration of private sector involvement in the project	Until construction of the facility is complete (plus the defects liability period)	Normally for at least 20-40 years for construction related PFI projects
Specific company involvement	Appointed by the public sector client on an individual basis for the supply of the specific skills	Involved as part of a concessionaire consortium or taking a key supply contracting role, being appointed by the bidding firm or concessionaire
Private sector risks	Specific to the area of involvement and limited to the defects liability	Wide ranging and long term
Remuneration	Lump sum or percentage fee	Annualized payment
Opportunity for private sector to suggest improvements	Limited	Considerable
Key financial considerations for the private sector company	Maintaining a positive cash flow and margins	Having an adequate asset base and debt facility
Attitude required of the private sector from the public sector	Reactive	Proactive
Responsibility for design, build, finance and operate	Lies with the public sector procurer	Lies with the private sector concessionaire
Accountability for the resulting services	Public sector procurer is accountable to itself/Parliament	The private sector concessionaire is accountable to the public sector procurer who in turn remains accountable to Parliament for the services provided.

Sources: Adapted from CIC (1998) Constructor's Key Guide to PFI and PFP (1996b) Risk and Reward in PFI Contracts p 1

Wang, *et al.* (2000), Ozdogan and Birgonul (2000), Tam (1999), Treasury Taskforce (1997), Songer, *et al.* (1997), UNIDO (1995), Drake (1994), Yates and Mukherjee (1993), have variously identified the key risk areas associated with privately financed infrastructure projects. These risk areas can be broadly categorized as Bidding, Construction and Operating Risks. Risks in privately financed infrastructure projects are heightened by the rather large capital outlays, the long lead time and the fact that financiers will have to exclusively rely on the project cash-flow for their returns. The genuine and prudent transfer and/or allocation of risks is therefore a critical factor in determining whether the private sector will respond positively to participate in a PFI bidding process including the realization of main objective of value for money. When tenders for the first two PFI custodial services, i.e. Bridgend and Fazakerley prisons were received, none of the parties invited to tender felt able to comply with the Prison Services' terms and conditions relating to the nature of risks they were being asked to bear. The invitation to tender resulted in non-complaint bids, which was quite an expensive procedure (National Audit Office 1997a).

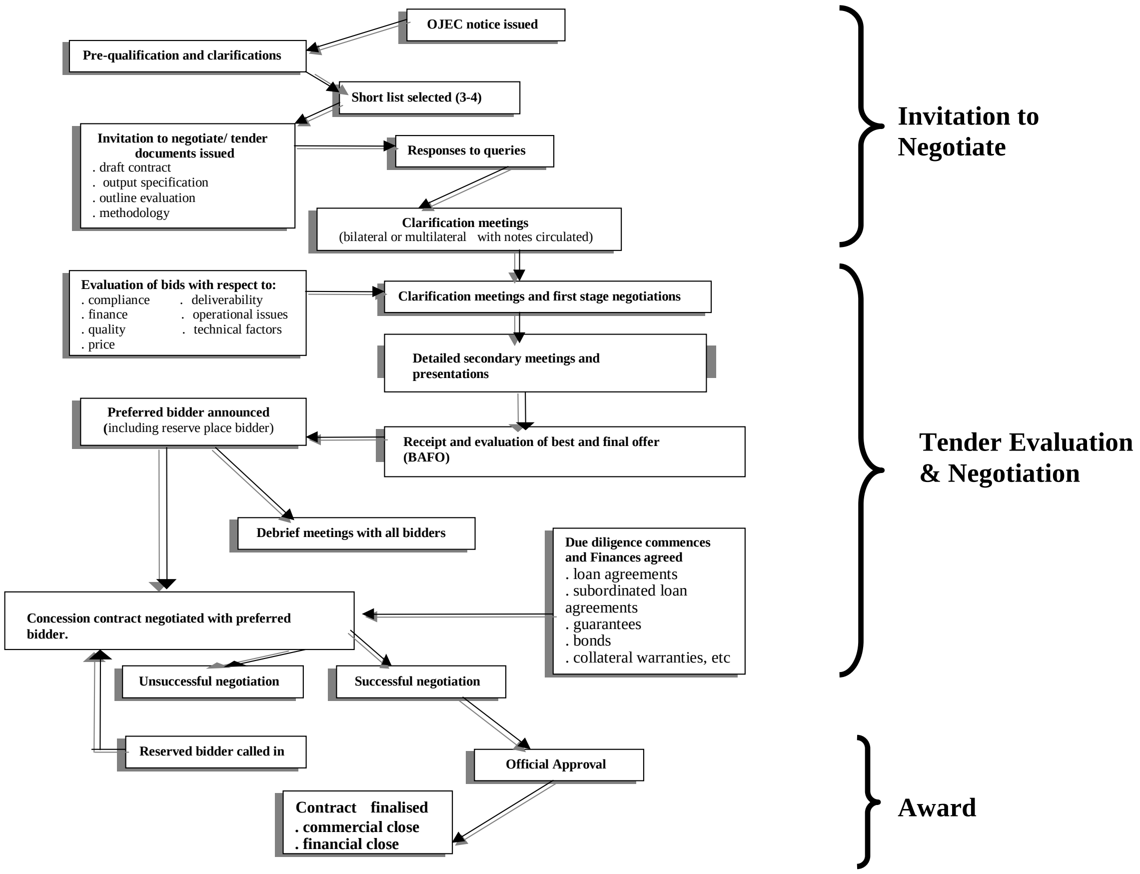

Figure 1: The PFI procurement stages up to financial close
Source: Adapted from CIC (1998) The Constructor's Guide to PFI

A commonly stated problem with PFI procurement is the rather long time it takes to conclude a deal due to protracted negotiations, and the high cost associated with the process. Owen and Merna, (1999) have identified these problems as being the reason behind several high profile withdrawals during the early PFI tenders, resulting in some preferred bidders being selected by defaults as other competitors withdrew. Bidding for a PFI project is usually much more complex than for a traditional public sector project involving the appointment of top advisers and designers at a great fee in the preparation of detailed design, comprehensive planning, extensive bid documentation, and lengthy clarifications. There have been suggestions from bidders that the public sector procurer compensates the bidders for some of the excessive bidding costs especially the second lowest bidder who is made to keep his bid on hold as a means of maintaining competitive pressure on the lowest bidder. The speculation that the National Lottery may compensate the Peoples Lottery consortium after failure to win the tender to take over the running of the game (Sunday Telegraph, 2001), may possibly set the tone for this call.

There is also the added perception that public sector managers have been 'cocooned' in a culture of 'rules not deals' (Gallimore *et al.*, 1996). Hence, it could be said that the public and private sector decision makers are dissimilarly conditioned in their attitude to risks and thus limiting sufficiency in the convergence of opinions on the level and degree of risk as to enable agreement on price to take place (Coopers and Lybrand, 1996).

Figure 2 gives an indication of the average cost of bidding for four DBFO (PFI) road projects at the various stages of the procurement process, while figure 3 provides a comparative picture of the proportion of bidding costs to total project costs

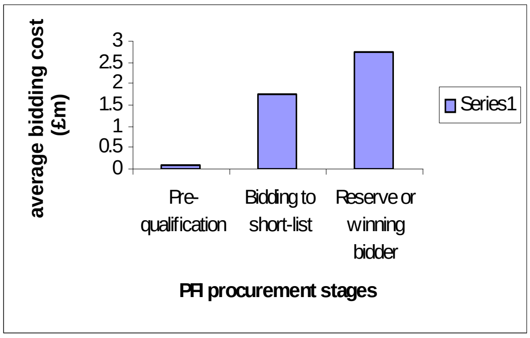

Figure 2: Average bidding cost of PFI road projects
Data source: National Audit Office.

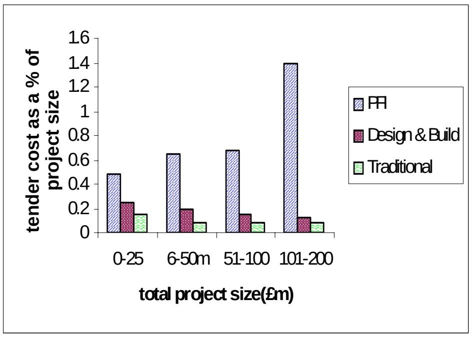

Figure 3: Tender costs as a % of total project cost
Source: HC treasury subcommittee 6th

The costs to the public sector departments in terms of consultancy and advisory fees have equally been quite high. Due to the uncertain scope of the works involved in letting the early PFI contracts, both the public sector agencies and the advisers found it difficult to set accurate budgets for advisers' costs. On some projects the principal advisers' costs were over 600% their initial estimates (National Audit Office, 1999a p 49)

In order for the private sector to provide innovative solutions, the design of PFI projects has been the responsibility of the bidders. Design errors become a risk for the private sector. On the A1(M) road project, one of the first four DBFO projects organized by the Highways Agency, the chief executive of the consortium, RMG, indicated that had it not been for the PFI procurement, they would have put in substantial claim for both time extension and cost for unforeseen ground conditions (House of Commons, 1998)

The risk of procurement time and cost overruns has been a feature of most of the PFI projects. In the case of the A74(M)/M74 DBFO road project in Scotland for instance, as a result of the extensive consultations with the bidders, the procurement time scale had to be revised from 17 months to 27 months. The result of this revised time-scale and other unforeseen events was that the procurement costs to the public sector procurer increased from £1.3m to £2.85m (National Audit Office 1999b).

THE RESEARCH FINDINGS

The overall research methodology has been based on the review of literature on PFI to identify the key processes and risk areas during the PFI procurement up to financial close. This was then followed by a questionnaire survey and structured interviews between August and September 1999 directed at the key segments of the construction industry in the UK, specifically targeting organizations and individuals that have been regularly involved in the PFI procurement process. The survey list was drawn from the 1997/8 PFI Report Yearbook containing a list of key players in PFI including public sector procurers, consultants/ advisors, contractors/operators, and financial institutions. In all 64 participants were served with the questionnaires and the response rate was 42%.

One significant risk area revealed by the survey is excessive time overruns experienced during the PFI procurement process. As indicated in figure 4, eighty five percent (85%) of the respondents confirmed that delays were a problem.

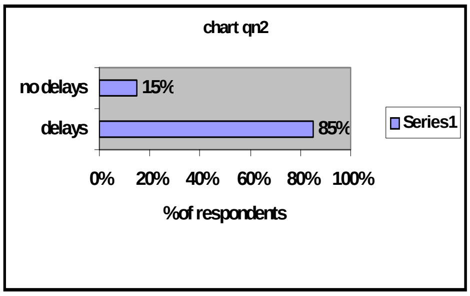

Figure 4: Delays during PFI procurement

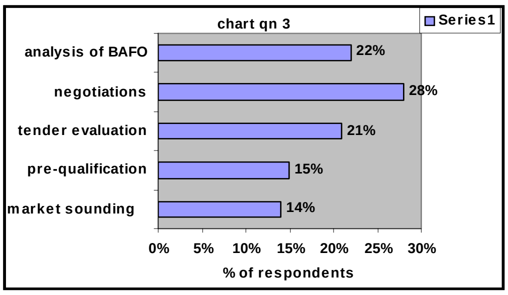

Figure 5: Stages of the procurement process at which delays are mostly encountered and considered critical in reaching early financial close

The industry was unanimous in singling out the post tender submission stages involving tender evaluations, negotiations and analysis of the BAFO as the critical stages where the delays are most paramount with the negotiation stage topping the list as in figure 5. The general opinion was that the public sector procurers would have to clearly define their needs more explicitly through the output specifications.

The impression gathered during the interviews was that the private sector appeared to arm itself with much more powerful negotiating teams than most of the public sector procurers. This was confirmed through the questionnaire survey by the fact that respondents from the private sector favoured the engagement of highly skilled and experienced professionals and in fact with greater preference for those with postgraduate qualifications than the public sector. One of the respondents suggested the early involvement of the financial institutions so as to speed up negotiation processes towards the early establishment of financial due diligence.

Part of the questionnaire survey was designed to gain an insight into the level of appreciation of construction industry practitioners as to the importance of value and risk management to the PFI procurement process. Generally, these two disciplines came out strongly as being vigorously pursued during project development. Again, the private sector however appeared to have a leading edge in this. The danger here then is that the risk levels may be perceived differently by the two sides and therefore rendering the negotiations more protracted.

As shown in Figures 6 and 7, the production of guidance notes and the organization of training seminars were rated high as making the necessary impact in pushing forward the procurement process. This may be considered significant in the face of the assertion that public servants are generally risk averse and would prefer to work within a culture of laid down rules rather than deals.

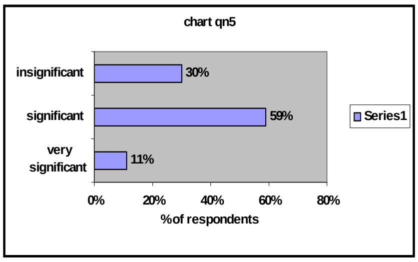

Figure 6: The significance of guidance notes in minimising delays

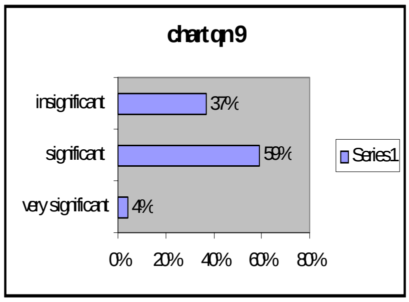

Figure 7: The impact of PFI seminars and workshops

CONCLUDING DISCUSSIONS

The foregoing research has attempted to expose the critical stages of the PFI procurement process that contribute most to the risk of delays and hence higher costs to the parties. First of all, the survey has confirmed the concerns raised in literature and the media about the rather long delays in the procurement of PFI projects and as a result the escalating costs not only to the private sector participants but also to the public sector procurers. Secondly it has demonstrated that the public sector procurers may become 'victims of mismatch' during the negotiation stages of the procurement process as the private sector generally are better armed with teams constituted by very qualified and experienced professionals. Thirdly, though the disciplines of risk and value management are being pursued to a greater extent during project procurement, the private sector has an edge over the public sector and thus increasing the likelihood that the perception of risk at both levels will differ significantly. This may increase the risk of prolonged negotiation periods and increased bidding costs.

Though the various institutional measures put in place such as training courses, seminars and guidance notes have proved to be helpful in smoothening the process towards reaching an early financial close, there is the need to intensify them in order to better equip the public sector procurers. The pulling of resources and the sharing of knowledge at this stage should help in situations where departments are attempting the PFI procurement for the first time. Resource pulling and knowledge sharing did work very well when the Scottish Office was developing their first DBFO A71(M)/74(M) road project, by soliciting assistance from their southern counterparts, the Highway Agency, who had earlier gained experience in procuring their first four pathfinder projects (National Audit Office, 1999b).

Finally, as reflected by the response to the survey there is a high level of enthusiasm out there within the private sector towards the initiative - a valuable asset that needs to be tapped before it waxes and wanes. It must however be emphasized that sustaining interest in the initiative does not end at reducing the risks at the early procurement stages. The PFI procurement is unique in the sense that the services are being procured by the public sector over a rather long duration with some spanning beyond two or three decades. The world being a dynamic system, issues will naturally arise along the line which will need to be resolved quickly if the process is to be judged as being successful. A typical case in point is the recent wrangling over why no claw-back clauses were included in the earlier deals for the public sector also to benefit from the profits being made by the private sector through refinancing. The PFI Report (2001) indicated that the Consortium for the Fazakerley PFI prison project received a windfall gain of £10.7m through refinancing by replacing equity with debt. The eventual success of the initiative can only be judged by how effectively and promptly these emerging issues are dealt with and how efficiently the services are delivered over the concession periods.

Further research is currently being carried to develop a broader outlook into the risks within this sort of procurement strategy.

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