

## **Overview of the MPA's 21st Annual Conference**

# **PFI/PPP Projects – are they working?**

(This overview was prepared by Betzy Dinesen and Jane Thompson)



## **Chairman's Introduction (Sir Alan Cockshaw)**

**A**s a starting point for the MPA's 21st Annual Conference, we commissioned a study on PFI and PPP from Henley Management College, which forms the subject of the first presentation after the keynote address. The aim of the conference is not simply to answer the question of whether PFI/PPP projects are working but to focus on better delivery and more effective performance. Knowing where the weaknesses lie will help clarify the solutions.

By 1997 PFI was already establishing itself (it had been around as a potential instrument for 15 years) and had become very much part of the culture of the industry, receiving great encouragement from the incoming Labour government. The strengths of PFI are that it can provide a total solution, but if it is to work, the different interests contributing to a major project have to be integrated into a proper partnership. A holistic approach to total solutions is at the heart of PFI.

The 21st Annual Conference can learn from the present and past in order to help PFI and PPP projects go more positively into the future, benefiting from an exchange of knowledge and experience and taking the best from of existing practices.

## **Keynote Address: Views of the National Audit Office on PFI and PPP (Sir John Bourn KCB)**

Are PFI/PPP projects working? The NAO believes they are and that they represent the way forward for project delivery and operations. This is also the government view, with specific endorsement from the Prime Minister. PFI/PPP has become the means whereby government takes forward public projects, an approach seen not only in the UK but also around the world. Internationally, there is a wide interest in UK experience, which might serve both as an earning asset for the UK and as a beneficent gift to the international community.

The auditor general is the external auditor of British central government, with 600 accounts, ranging from mega-spenders like the Department for Work and Pensions down to smaller concerns such as Kew Gardens. The NAO has produced over 30 reports. A recent report on managing the relationship to secure a successful partnership in PFI projects identifies three factors for success: true partnership, communication and commitment. While that might seem obvious, these three vital constituents are often lacking in PFI projects, as a result of cultural entrenchment and hostile perceptions. NAO research shows that where projects have not gone well, difficulties can almost always be traced back to people's perceptions of one another, although some progress in changing the culture has been made.

Where the three conditions of true partnership, communication and commitment are in existence, a PFI project can withstand other problems. A case in point is the PFI project for National Savings and Investment, with PFI partner Siemens. Through trust and partnership, various project problems have been overcome.

A recent NAO report shows that before PFI, 70 per cent of central government construction projects suffered time and cost overruns; since PFI, the figure has dropped

to 20 per cent. One of the main reasons for this substantial improvement is better handling of risk. There is room for improvement in PFI and PPP, but by and large they are working.

**First Discussion**

The discussion covered the NAO’s approach to evidence, front-end costs of PFI projects and the deterrent for new entrants, concession lengths, the role of the auditor general, auditing and assessing projects and lack of direct project experience among senior civil servants.

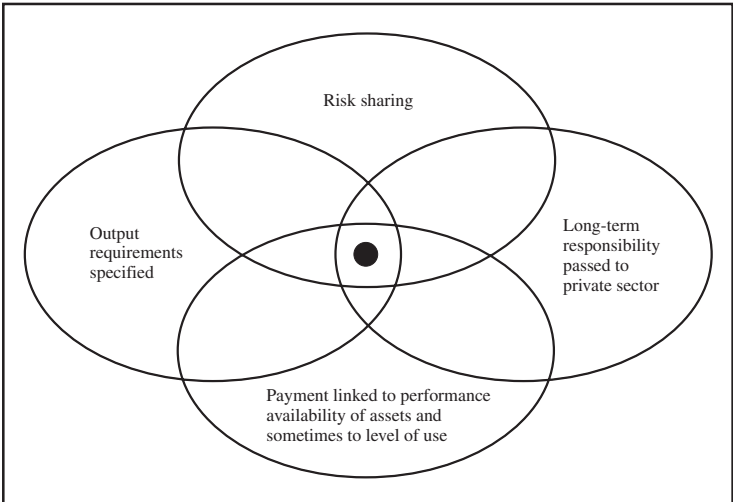
**Results of the Henley Research Study (Jeff Zitron)**

MPA commissioned Henley Management College to conduct research into whether PFI and PPP are working. The researchers conducted 60 interviews covering 22 stakeholder groups from different backgrounds. The study looks at three types of arrangement: PFIs, PPPs and the wider markets initiative. PFIs are defined as having four main features: they are projects where significant risk is passed to the private sector, output requirements are specified (rather than specifying in detail the assets and services), long-term responsibility for maintenance remains with the private sector and the contractor’s payment is linked to performance and availability (Figure A). Some PPPs are almost indistinguishable from PFIs (e.g. the London Underground PPPs) and this is arguably a question of labelling and politics. However, two distinguishing features of PPPs can be identified, especially in projects such as the Channel Tunnel Rail Link and the National Air Traffic Service. First, the public sector is part-owner of the service-providing organization (i.e. there is part privatization of public assets) and secondly, there is more fluidity and greater uncertainty about investment over the concession period. The third form of partnership, the wider markets initiative, is outside the scope of the presentation.

PFI and PPP has so far produced over 500 {JZ see main text – 600+?} deals, with a capital value of more than £35 million (Figure B/ Exhibit 2). Investment under PFI has more than doubled since the Labour government came to power, although PPP/PFI expenditure is relatively small in terms of overall government expenditure. The scope of projects is wide. Schools and hospitals predominate, but there are many other types of project.

The Henley study brings together the views of a variety of stakeholders: service users, the taxpayer and the Treasury, public sector clients, employees and unions, the construction and IT industries, operators, funders, insurers and professional advisers.

Highlights of the report include strong evidence that PFI projects are far better at keeping to time and budget than other forms of procurement, a clear benefit to service users. The evidence on quality of service is mixed. This is probably due to an inadequate evidence base and the fact that it is still early days. The good news for the taxpayer is that



**Figure A Main elements of PFI**

- 564 deals
- Capital value of £35.5 billion
- 90 per cent signed since 1997
- Investment under PFI risen from £1.5 billion in 1997–8 to £3.7 billion in 2002–3
- But (excluding Tube PPP) PFI and PPP together less than 15 per cent of government capital spend

**Figure B Scale of PFI/PPP projects**

PFI projects generate savings to the public purse during the construction period. PFI and PPP allow projects to be funded throughout the economic cycle, which is attractive to governments taking the long-term view and anxious to keep public borrowing down. The argument that it is cheaper for the government to borrow money is not sound. The real cost of borrowing is the inherent risk of the project. The cost of financing to the private sector finance has the element of risk built into it, whereas government funding of a project is underpinned by what is, in effect, a blank cheque signed by the taxpayer. In fact, it is probably a benefit that the risk element in the price of private capital is more explicit.

On the client side, procurement skills vary considerably and government initiatives, including the creation of the procurement agency Partnerships UK, are attempting to remedy the problems. Some projects are now being procured in bulk. Employee resistance to transfer to is understandable. Although employees are protected by the provisions of TUPE (Transfer of Undertakings (Protection of Employment) Regulations 1981), the government has been tardy in addressing the legitimate concerns of the workforce. The code of conduct on the two-tier workforce, set up to prevent new employees from having substantially worse terms than those who transferred from the public sector, has only recently come into being.

On the supplier side, the construction industry has complaints about the system, particularly about procurement delays and costs. However, the construction contractors interviewed during the research are generally content with the returns and are not about to withdraw from the market. The situation for new entrants to PFI/PPP is different, and the complexity and cost of the system are a deterrent to new players.

It is sensible to include operations or hard FM in the PFI package, since there is a clear link between sound initial construction and ease of long-term repair and maintenance. Soft FM is more controversial. There is some evidence of under-costing and contractors losing money. Over-frequent retendering for soft FM contracts (every five to seven years) makes them less attractive and in any event public sector hostility has led to a government decision that the public sector can retain soft FM services.

IT projects procured under PFI have not fared well and the Treasury has announced that major IT projects will no longer be procured through PFI.

On matters of funding, the market for PFI lending is small, with two lenders, Halifax Bank of Scotland and the Royal Bank of Scotland, dominating the market. The market for PPP lending is somewhat larger. Projects have received good credit ratings and the credit agencies regard PFI and PPP as a sound investment, although government attempts at transferring too much risk to the private sector might damage the ratings of some projects. Other financial developments include the emergence of a small but strong equity funding market and a government experiment in funding projects through gilts. The insurance market has been affected by 11 September 2001.

Professional advisers play a valued role in acting as a conduit for spreading experience among client bodies, but complaints about high costs were heard during the research.

Future challenges include the need to nurture good-quality long-term relationships, based on trust, partnership and the desire to work well together. Continuing high-profile opposition from trades unions still has to be overcome. Information on future deal flow is critical to commercial decision-making among contractors, and in fairness to the market, government has to give information on its programmes much further in advance. If it does not, the contractor market might not always be available when it is needed, and the flow of deals and the capacity of the market may be out of sync. In a nutshell, the government needs a “business plan” for PFI and PPP.

Press coverage of PFI and PPP is often negative, even ill informed, blaming PFI

for issues unconnected with PFI, especially in the area of hospital management. More equitable scrutiny has come from the National Audit Office, the Audit Commission and Audit Scotland. Internal review should be encouraged.

## Appropriate Use and Effective Management in PFI and PPP

(Mark Richardson)

The evidence to date on the success of PFI projects is promising. NAO studies, broadly speaking, have reached a positive conclusion, while a Treasury paper has found good performance on project delivery to time and within budget, together with largely satisfactory operation so far. When it works, as it frequently does, PFI offers smooth, effective procurement, real cooperation between the parties and value for money. At the same time, it is often frustrated by procurement delays, changing objectives and the high cost of bids. Disappointing performance on PFI projects can be laid at the door of poor project definition, the inappropriate use of PFI and poor management.

Good project definition requires high-quality investment appraisal, understanding of the business objectives, analysis of the business, technical and financial issues and consideration of the full range of options. A simple matrix (dubbed a “success predictor chart”) shows how prospective PFI projects can be analysed using two dimensions, quality of management and appropriateness of the PFI model (Figure C).

Provided that the project is suitable for outsourcing, a number of factors will help to determine whether PFI is the right choice. These factors include project scope (well defined and stable?) and synergies. If the potential synergies are significant, there may be a good case for PFI. This whole area is probably under-exploited and a notional PFI accommodation project is cited as an example of the synergies that may be found between the four main areas of design, construction, operations and finance (Figure D).

Other questions to be asked in determining whether PFI procurement is appropriate are: is there

	<i>Project more appropriate for PFI</i>	<i>Project less appropriate for PFI</i>
<i>Good management</i>	<b>Success</b>	<b>Successful delivery of indifferent value for money</b>
<i>Poor management</i>	<b>High risk of project failure</b>	<b>Disaster</b>

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Figure C PFI success predictor chart

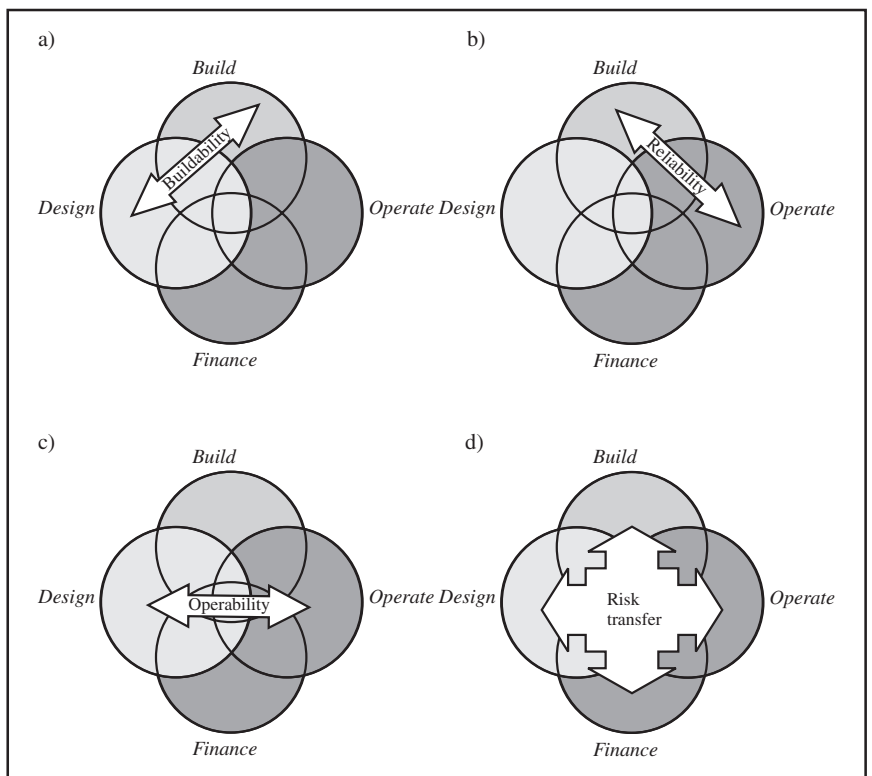


Figure D Synergies in an accommodation project: a) between design and construction; b) between the building process and the operations phase; c) between design and operation; and d) finance and risk transfer

potential for effective (and fair) risk transfer, is there scope for innovation, what is the cost of capital and would the assets have alternative uses, either during or after the contract period? The possibility of third-party income is something of a red herring and its benefits in the real world are dubious.

Poor management may be the result of poor definition of the project scope (it is not unknown for clients to prevaricate and change their mind) or an ineffective mechanism for managing changes. Clients are not always aware of the affordability constraints and their expectations are larger than their budgets. One example is clients whose PFI specifications require better property maintenance than has ever been delivered in the past and for which there is no historic budget allowance. Further causes of bad management are inadequate governance arrangements, weak stakeholder management and ineffective partnering between client and PFI consortium. PFI projects require strong project planning and management skills, combined with finance and commercial skills.

Tips for making PFI work better include a return to basics (better investment appraisal, better project management, better skills) and proper scrutiny of whether the project is best done under PFI. Hybrid models can be useful and gainshare may have a place. Learning across procurement strategies (PFI, strategic partnering and prime contracting) which have much in common with one another should be encouraged.

## **Second Discussion**

The discussion covered conflicting interests on an SPV board, involvement of end-users, the value of design, build, finance and transfer (DBFT) as a model for PFI/PPP, whether bid costs were a deterrent to contractors, reimbursement of bid costs and whether bid costs were a barrier to entry into the market, selling the business case for PFI and the PRIME contract for the DWP.

## **Public–Private Partnerships in Prison Construction and Management** (David Kent)

In the 1980s the Prison Service was perceived to be something of a dodo, with inflexible attitudes and an outdated culture. Even before the advent of PFI, the private sector was brought in to manage four prisons in order to achieve greater efficiency, value for money and an improvement of standards and attitudes. In 1993, PFI came on the scene, and the Prison Service embarked on prison procurement under the PFI regime. A DCMF process was adopted (design, construct, manage and finance) and to date seven prisons have been built and begun operating. The first three contracts (signed between December 1995 and November 1996) were among an early tranche of PFI contracts let before 1997. In addition to the existing seven PFI prisons, two further PFI prisons are due to open in 2004 and 2005 (Figure E).

The procurement of the physical assets has been an unqualified success. All seven prisons have opened on time or early and all have opened to cost. They were delivered in about half the time taken by prison projects under previous routes of public procurement. They were also delivered at a far lower cost, and the PFI route led to lower capital costs than 10 years ago.

This remarkable turnaround is in part due to the new approach whereby the private sector is invited to bid and use their skills to come up with innovative design and construction techniques in response to an output specification. In the old days, the Prison Service itself would create a massive and highly prescriptive design brief. Requirements and design changes are now more contained. By letting the entire service to the private sector, synergies between the operator, the designer and the constructor can be achieved.

The client retains risk in the areas of contract specification, contract award, demand, residual value and accountability. (The private sector clearly has no control over demand, i.e. the numbers admitted to prison!) Risks are transferred in the area of design, construction, maintenance, management and finance. The four phases of the wider process are standard: competition, contract negotiation, the construction period and operations/management. The construction period so far has lasted between 18 months and two years, and operating contracts run for around 25 years.

The main parties in a PFI prison project during construction are the Prison Service {text qy to DK, “Correctional Services”?}, the independent engineer, the constructor, the operator and the banks, together with various stakeholders, i.e. local authority, the public and the media. During the operational period, the parties are the Contracts and Competitions Group, the area manager and the controller within the Prison Service; outside the Prison Service are the operator and the banks (plus, again, the local authority, public and the media as external stakeholders). The transfer of the entire service brings capital and operational benefits, but there is a political downside, as some believe that the private sector should not be involved in managing prisons.

Regulation and scrutiny are provided by the Criminal Justice Act, the Prison Rules, the controller (who acts as on-site contract manager and carries out certain legal functions), the Chief Inspector of Prisons, the National Audit Office and the internal audit system. Other regulatory structures are a prison Board of Visitors and the prison ombudsman. To ensure quality and good performance, construction performance measures, incentives in contracts, KPIs, compliance monitoring and audits are all used. Despite the mixed conclusions from the most recent report of the NAO, experience of prison operation is generally good. The Chief Inspector of Prisons, who is not part of the Prison Service, was also positive. Finally, a recent report from the CBI has shown that competition in prison management is saving the taxpayer over £40 million a year and has hailed PFI as engineering a revolution in prison management. {DK in text is asked to give a firm figure for savings, as he gives a broad span of £40 million to £60 million a year.}

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### Third Discussion

The style and quality of prison management, prison design, future standards in PFI operations generally, overcrowding in prisons, assessment of the PFI regime in prisons,

	<i>Location</i>	<i>When contract signed</i>	<i>Contractor</i>	<i>First prisoner received</i>	<i>Certified normal accommodation</i>
Parc	Bridgend South Wales	4 Jan 1996	Securicor + Skanska/ Costain	Nov 1997	800
Altcourse	Merseyside	20 Dec 1995	Group 4 + Tarmac	Dec 1997	600
Lowdham Grange	Nottingham	7 Nov 1996	PPS + Kvaerner	Feb 1998	500
Ashfield	Near Bristol	29 June 1998	PPS + Kvaerner	Nov 1999	400
Forest Bank	Salford Manchester	2 Jul 1998	UKDS + Tilbury Douglas	Jan 2000	800
Dovegate	Staffordshire	24 Sep 1999	PPS+ Tilbury Douglas	9 Jul 2001	800
Rye Hill	Onley near Rugby	22 Jul 1999	Group 4 + Carillion	21 Jan 2001	600
<i>Future prisons</i>					
Ashford	Middlesex	Dec 2002	UKDS	June 2004	450 females
Peter- borough	Cambs	Feb 2003	UKDS	Mar 2005	840 (480 males and 360 females)
Note: PPS = Premier Prison Service (contractor)					

Figure E DCMF prisons in England and Wales

anecdotal evidence, measures on re-offending and rehabilitation programmes were all discussed. PFI projects in the prison sector are said to be easier to manage than other PFIs.

### **PFI in Highway Projects** (Stephen Tarr)

The market for PFI in highways has progressively matured over the past seven years. PFI highway projects are carried out under DBFO contracts, i.e. design, build, finance and maintain a length of new (and often existing) road. The first tranche of DBFO roads in the UK reached financial close in 1996. So far, 13 deals have been signed, with a total capital cost of over £1.7 billion. The debt–equity ratio is usually 90:10. Most DBFOs involve a significant element of new build, accounting for 75–85 per cent of the net present value of the contract. Concessions run for 30 years. There is a high level of prescription in the technical specification. Nonetheless, the DBFO should lead to better long-term value by encouraging greater integration of design, construction and maintenance.

There is a high level of risk transfer to the private sector. The supplier takes the risk that its designs are fit for purpose and the latent defect risk. It is required to indemnify the client for the sufficiency and performance of its own standards and technical requirements. There is protection against discriminatory changes in law. The underlying principle in PFI is that value for money will be achieved where there is an optimal transfer of risk. This approach is grounded in common sense. If an authority tries to transfer risk unreasonably, the private sector will price that risk highly, so that the client will not get value for money. This, at least, is the principle. The practice is that the private sector is still being asked to shoulder inappropriate risk.

PFI has provided new market opportunities for the private sector. Without the PFI approach, the Highways Agency would not be in a position to fund these DBFO projects conventionally. In other words, the DBFO projects have increased demand. There are opportunities to earn rewards if risk is properly identified and well managed. PFI is working well in providing greater certainty in project delivery, and in three out of four PFI highway projects, certainty is being delivered, as shown by NAO analysis. It is borne out by anecdotal experience, which also shows that positive margins have been generated, a testament to the incentive to control costs and manage risks. This is largely due to the closer integration of design and construction processes and the greater involvement of second-tier suppliers and subcontractors at an earlier stage in the project cycle.

The life-cycle approach to costs under PFI is working well. PFI has encouraged long-term thinking on asset provision, maintenance and renewal, overcoming the conventional divide between the various interests. PFI concessions also encourage companies to think harder about the balance between capital costs and maintenance costs. There is no universal answer and the contractor has to make case-by-case assessments on bidding each project. Getting it right is key to success, getting it wrong could be costly.

So far, so good, and DBFOs can be good for both sides. The supplier's real complaint is the lack of continuity. There is a serious absence of deal flow and DBFOs have been coming to market in a stuttering way. This means that the detailed knowledge acquired by individuals is dissipated and the opportunity to identify efficiencies and improvements for new bids is being lost. Another problem is the constraint on innovation, which arises out of the planning restrictions, environmental statements and so on. This is not a criticism per se, but if the real scope for innovation is to be exploited, suppliers have to be involved before the planning commitments are made. In other words, there has to be early contractor involvement. Other problem areas are the time

and cost involved in the bidding process (Figure F). It is not uncommon for DBFOs to take nearly two years from receipt of tender documents to financial close and to cost more than £3 million. The DBFO highway market is highly price-sensitive and to date there has been little opportunity to differentiate on the basis of quality of service.

As the DBFO highway market has matured, competitive tensions have intensified. Lower rates of

return and excessive risk transfer make it a less attractive market to contractors. The Highways Agency is aware of industry criticisms and has put forward suggestions for improvement, which include speeding up the bidding process, minimizing transaction costs and selecting suppliers on the optimal combination of quality and price. It recognizes the importance of securing the benefits of early contractor involvement and maintaining a competitive and sustainable market.

#### Fourth Discussion

The fourth discussion covered the attractiveness of DBFOs to contractors, traditional forms of contract, bid costs and the forthcoming programme of highway projects.

#### PFI Projects in the IT Sector (Trevor Marchbank)

IT is a less mature industry than construction. There are fewer large players; instead there is a proliferation of small and medium-sized enterprises (technical barriers to entry are low and there are numerous experts in different subject areas). In the construction industry, specialist roles and professions are better understood, and construction operates in a regulatory environment. There are often repeatable requirements in construction projects, while rarely happens in IT. In one way or another, construction, as a more mature industry, has had the opportunity to learn the lessons of the past, something that IT has not noticeably done. In any event, profitability in IT is now falling.

The disappointing track record of IT projects probably has something to do with their unique characteristics. IT projects are particularly hard to specify and user expectations vary widely. Interfaces are complex and there are issues with legacy systems, data migration and transition periods. There is a multiplicity of links between the software being developed and the business processes of the client organization.

EDS has done a number of IT projects for public sector clients under PFI, with mixed results. On the negative side, there is a struggling project for the Child Support Agency (the CS2 project). A whole new system is being developed to respond to a massive business change, in a one-off project with a unique set of requirements. Developing the new software to meet the business processes is challenging, and the project will now be delivered late and over budget. There have been more successful projects, however, including the Focus 95 contract, under which EDS has taken on the running of four data centres responsible for printing and distributing benefit cheques for claimants, and the Quantum project for the Prison Service, which has rolled out an extensive IT infrastructure in 143 prisons in England and Wales.

{JZ EDS's candid views on the CS2 project, which is coming in over budget might be tempered in a document for public consumption. While everyone knows that it is

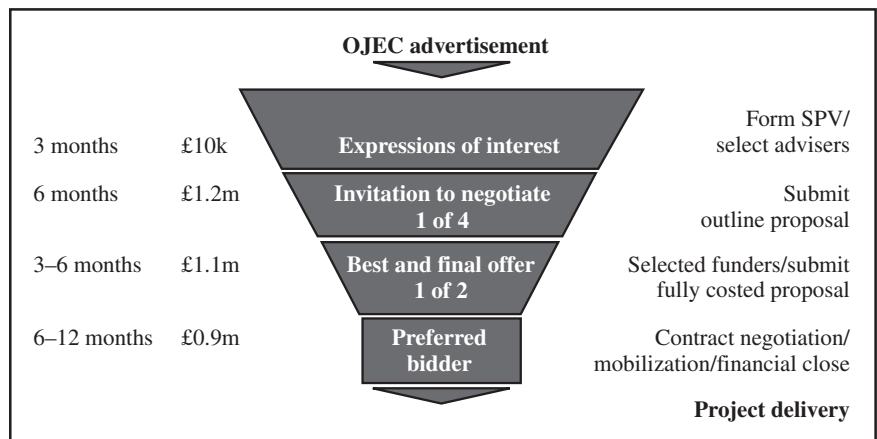


Figure F PPP/PFI bidding process

late and over budget, EDS might want to have their own spin if MPA is publishing this for anyone to read. JT}

If the delivery of IT projects is to be improved, there has to be a clearer focus on the output or service required, not on the system itself. Contract lines have to be drawn in an optimum position, somewhere in the broad area of IT applications and infrastructure, not in the more volatile area of business processes themselves. Following on from this, PFI should be applied to the appropriate parts of the life cycle, i.e. implementation and operation, not software development. Although it may all be too late, with the Treasury decision to withdraw IT projects from PFI, EDS is putting its views to the Office of Government Commerce on how best to use PFI for IT projects.

### Financing and PFI (Tim Treharne)

Most PFI and PPP projects are done using project finance. According to the Treasury report of July 2003, PFI leads to better project delivery (88 per cent of PFI projects were delivered on time or earlier), better value for money (offering between 5 and 40 per cent better value) and a more consistent quality of services. Risk transfer lies at the heart of financing in PFI. Risk is highest in the early construction and commissioning phases and tails off during the operational period (Figure G). Certain risks have proved particularly trying for the financial markets in PFI projects, notably traffic risk, to the extent that for the light rail sector, the financing market is no longer prepared to deal with traffic risk. Traffic forecasting is simply not good enough.

Lenders are concerned about risk in two main areas: the revenue stream and “termination compensation”, which is used to pay out any outstanding debts when the project comes to an end. For the latter, there is a wide range of “compensation”, from zero on DBFO road projects to 95 per cent on the London Underground deals. (JZ TT has been asked to clarify 95 per cent of what in text. JT). Key subcontractors are also asked to assume risk on their subcontracts.

The market for project debt is influenced by various factors, including the contractual structure of the project, risk allocation and the reliability of revenues. Terms and conditions of the debt will depend on maturity, purpose of the project, probability of default and so on. Pricing is more unpredictable, varying with the wider package of risk on the project and to some extent with market fluctuations.

The banking market has shrunk in recent years. In the days of Eurotunnel, there

were 300 banks engaged in project lending, but the number of lenders today is far smaller. The reduction in capacity, however, will not affect the majority of PFI projects, most of which are well within the capacity constraints of £1 billion. Mega projects are another matter and may have to be broken up into smaller projects in order to get private sector funding or alternatively secure government funding or guarantees. Third-party equity is available from both institutional investors and the major project banks, usually in the form of subordinate or mezzanine debt. It can also be used to give lenders a stake in the business and align their interest with the equity sponsors. There

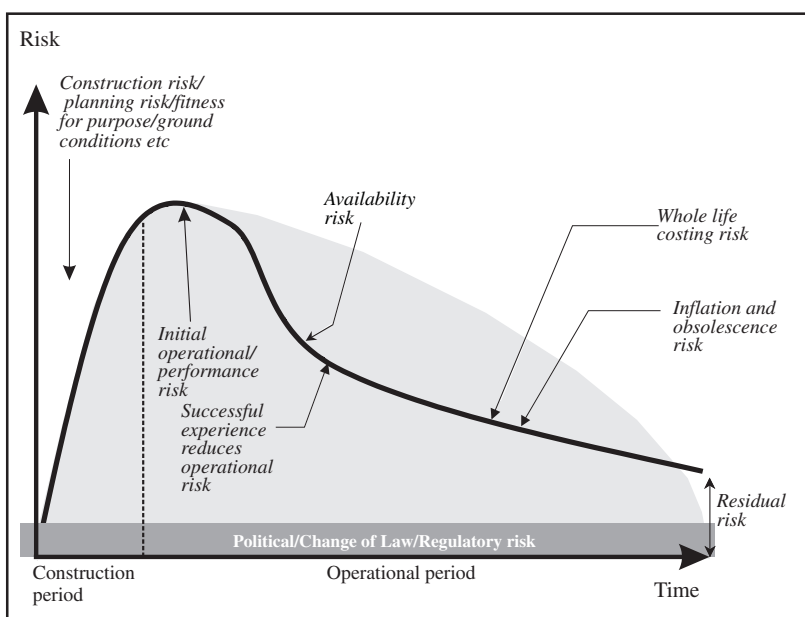


Figure G Risk profile of a typical PFI project

is an increasing use of the bond markets to fund PFI projects. The index-linked market has shrunk, but refinancing is coming on stream and secondary trading is also current.

Most developed countries are looking at the possibilities offered by the PFI/PPP models, although they have not so far featured in many real-world projects. Programmes of projects exist in a number of European countries and in Canada, and the International Financial Services, London, an organization which promotes the UK financial services industry, is in contact with 40 different countries around the world.

## Fifth Discussion

The discussion covered the complex relationship between business process and software development, capital and operating costs in conventional and IT projects, problems besetting public IT projects, PFI/PPP projects around the world and standardization.

### Client Experiences in the Hospital Sector: the Norfolk & Norwich University Hospital (Rob Smith)

The Norfolk & Norwich University Hospital was built and now operates under PFI. It serves a population of around 500,000 to 800,000 and employs about 6,000 staff. The annual income of the trust is £230 million. The hospital was built on a greenfield site and was intended to replace three existing hospitals (although one was in fact left open to provide a local community hospital). As the project moved forward during procurement and design, the number of beds has risen steadily from about 700 to 989.

The structure of project is shown in Figure H. The project company is Octagon and the concession period is up to 60 years (with a break option at 30 years). The FM contracts are being handled by Serco, running for five years. Getting a realistic timetable is essential for a hospital project and it is here that traditionally procured schemes have often fallen down in the past. On the Norfolk & Norwich University Hospital project, three bidders were selected in 1996, a contact was signed with the successful bidder in 1998 and over 800 beds were occupied in October 2001.

While contractors always suffer the problem of high bid costs, things are hardly rosy on the client side. The cost of pursuing these schemes to the NHS is extremely high and it has to be assured of competitiveness and quality. One party is a clear winner here: consultants. An observer once prophesied that PFI would be the death knell for consultants, but nothing could be further from the truth.

This was a pilot NHS scheme, so in effect a model contract was being drafted, and many of the terms have since been incorporated in standard PFI contracts, a gratifying outcome for the team. Design development was hard to manage. There had been a long wait for the new hospital and existing hospital staff were keen to get in and work with the designers. Managing user input and expectations was a difficult task. Securing funding also took time, and the funders' due diligence was searching and extensive,

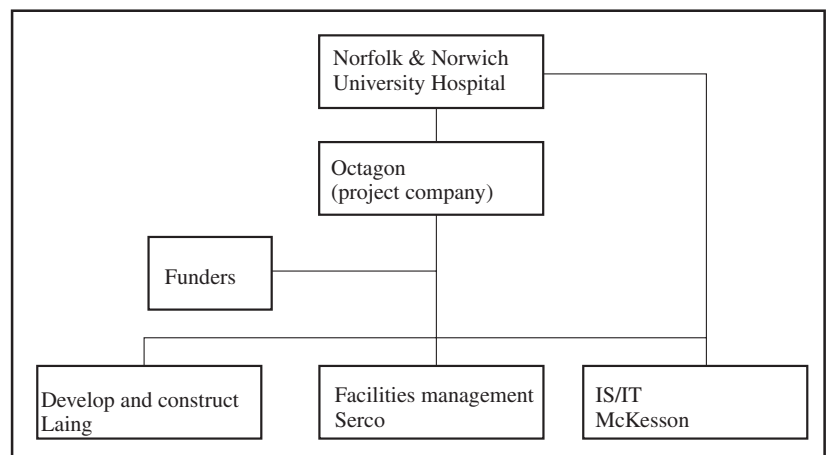


Figure H Structure of Norfolk & Norwich University Hospital (N&NUH) project

a process that rather showed up the inadequate risk management of the NHS in the past.

Specification for the design development was not easy against a background of changing practices and technologies in healthcare. Value engineering was also positive, for example for emergency power supplies. Although the project company Octagon was helpful in getting necessary changes through the process, the multilayered approval mechanisms are cumbersome.

Two years before the hospital opened, plans for the new regime were made. Non-clinical staff transferred to Serco, the company managing hard and soft FM. Training was given where needed and all staff were given the opportunity to visit the new hospital and familiarize themselves with it, but less than half did so. Overall, the move went smoothly, although problems over hospital equipment were experienced and key medical equipment was not in place soon enough. This should have been better dealt with in the contract.

Good team building was done and the lessons recently learned on the outsourcing of FM were taken forward to the new hospital once it opened. All this paid off well. For example, a patient survey on the quality of the food, taken within six months of opening, produced impressively positive results (93 per cent said the food was good or excellent). Early problems with the portering system were remedied within 24 hours, thanks to the trust that had been established with the FM company. Having a contract with an FM company for only five years is surely a strategic misjudgment, since frequent changes in the service providers is hugely disruptive. A growing problem in the delivery of FM is the high level of occupancy of the wards; over 90 per cent (indeed in the high 90s) as against the 85 per cent occupancy originally envisaged. It is extremely difficult to free up space for maintenance.

The Norfolk & Norwich University Hospital is much appreciated by patients. The PFI parts of the hospital are working well, and although there have been problems (public transport, road access), they are unrelated to PFI. Risk sharing, speed of delivery, teamworking and standards have all been deemed to be successful, even highly successful. In a changing health service, unfortunately, some of the goalposts have already been moved and yet more capacity is needed. With hindsight, communication could have been handled far better and, of course, some staff have fond memories of their earlier hospital careers in a different, albeit less modern, environment. That is just a fact of life, not a fault of PFI.

### **Operating a PFI/PPP Facility: Supplier Experience in the Healthcare Sector** (Michael Hobbs)

Carillion has a wide range of PFI experience, including operational experience in four sectors. In healthcare, it has operational experience in four hospitals, starting with the Dartford and Gravesham Hospital in 2000. In the earlier PFI schemes, there was no FM involvement at the design and construction teams and the FM people came on the scene in the last few months before project delivery. They were given the operational manuals and told to get on with it. Happily, things have moved on since then, and the special-purpose vehicle, or project company, has an interest in laying the foundation for high-quality FM during the life of the project. To that end, there is greater FM involvement earlier on and better integration during handover. All this is a far cry from the style of NHS trust boards, where reports on the maintenance regime are unheard of. SPV boards, by contrast, have a strong interest in maintenance regimes, and there is a real incentive to perform well.

The NHS culture means that the client is still over-concerned with input (i.e. the mechanics of achieving a certain level of service) rather than the output (the service

actually received). In the provision of portering, the NHS client may become concerned that one week there are 50 porters, while another week there are only 46, without realizing that the same level of service is being provided.

Because of the high turnover among senior managers in the NHS, continuity is lost, and the NHS managers who were around at the signing up of the deal at an individual hospital may already have moved on by the time operation begins. The NHS client sometimes confuses the SPV and the subcontractor providing the FM service. In reality, this is a tripartite relationship that has to be well managed.

The NHS is a dynamic environment and subject to change, so that over time more facilities or different facilities will be needed. Clients have to be aware that the transaction costs of variations can be high and not embark lightly on change. The timescales for achieving change have to be realistic. If variations are funded through PFI, they will become less and less affordable as the concession runs down, and different mechanisms may be needed to deliver variations.

PFI has made a significant contribution to the long-term management and whole-life costs of projects by closing the loop between those who design, those who build and those who operate the facility. The lessons learned on one scheme inevitably have to be carried over to the next, so that the current scheme does not necessarily benefit individually from the lessons learned. The first wave of schemes is now starting to demand the same level of service at no extra cost. Again, expectations have to be managed!

The rewards for the private sector are market opportunities, a return on equity and increased turnover and profit. The construction phase of PFI projects is seen as reliable but it is too soon to judge the success of PFI provision of FM services and maintenance, and the jury is still out.

## **Union and Workforce Perspectives on PFI/PPP Projects**

(Geoff Whitlow)

The union Amicus—AEEU has a strong presence in the health service and other parts of the public sector, although only around a thousand are affected by the current PFI programme. The union is unique in its involvement at both ends of the PFI cycle, construction at one end and FM at the other. In asking whether PFI and PPP are working, one has to put the question in the wider context of the public procurement of construction projects in the past. One horror story is Guy's Hospital Phase 3 development, with time and cost overruns to astound even the most cynical project practitioner. The project came in over £68 million over the approved budget, at a total cost of £151.8 million. It was known as the Klondike among the workforce. The project was done under a regime of a licence to print money. Little wonder that the discipline of private sector project management was needed.

The profile of Amicus members in the health service is that of an ageing workforce. The average age of members working in hard FM is about 55. This ageing profile is not peculiar to Amicus, and the health service in general has an ageing workforce, which may well precipitate a crisis in nursing in the future. A survey conducted by Amicus among its members in hospital PFI employment has shown that employees who have transferred like working for an FM specialist, who has a proper understanding of the actual job. The new FM providers also place a greater emphasis on training. Another plus for Amicus members is the ability to get an answer quickly. In health service employment, procedures are arcane and cumbersome. Private sector FM providers, by contrast, are brisk in providing an answer—as far as the FM worker is concerned, a swift answer, even if it is no, is better than NHS bureaucracy. The survey has shown that, all in all, a real team spirit has been forged.

The major downside, however, is the question of pensions, with Amicus members understandably anxious to preserve their final salary schemes. The union has done a great deal of work over pensions to secure broadly comparable provisions for members who have transferred. Older membership in healthcare and concerns about pensions have led to a degree of resistance to the pace of change. But change is clearly needed in areas such as pay, where the Whitley pay structure has not changed much since 1948. Reform over pay is now on the agenda in the NHS and will take time, in strong contrast to the PFI hospital sector, where negotiations over terms and conditions have in one example been rapidly conducted, to the benefit of members.

Before 1997, the protections offered to employees transferring under a PFI arrangement were not properly developed and the transfer of staff in the first-ever PFI hospital, the Cumberland Infirmary at Carlisle, was poorly managed. Improvements made by the government in the management of hospital PFIs have earned the acceptance of more union officers and members. Soft FM is no longer to be taken into the PFI fold, however. Clear, frequent communication with hard FM employees is necessary if a transfer is planned. PFI could be said to be working as far as Amicus members are concerned, but it has to be managed efficiently, openly and sensitively.

### Sixth Discussion

In the sixth discussion, Rob Smith, Michael Hobbs and Geoff Whitlow formed a panel, representing the views of the client, supplier and union. Topics included the question of whether soft FM services should be included in the original PFI contract, the lengthy approval procedures in PFI and the need for flexibility in operations (there was also dissent here), high staff turnover and skills shortages in the health service.

### PFI/PPP Projects Now and in the Future: the Treasury Perspective

(Geoffrey Spence)

In July 2003, the Treasury published PFI: Meeting the investment challenge, which clarifies the government's approach and commitment to PFI and forthcoming policy changes. Misconceptions about PFI have gained a wide currency. They include the belief that PFI capital investment in the public sector is massive, that government pursues PFI to keep debt off its balance sheet and that we are mortgaging our future through PFI. PFI is said to be more expensive than conventional procurement, jeopardizes workers' terms and conditions and has no future.

The Treasury document shows that these arguments have no substance. PFI investment constituted only 11 per cent of total investment in 2003/03 (Figure I). Broken down by government department, PFI, as a percentage of a departmental capital expenditure programme, is small in the fields of health, MOD, the Home Office and devolved administration, and slightly larger for transport. All in all, PFI would probably never represent more than 10 or 15 per cent of capital investment in a year.

Despite the criticism that PFI is being overused in certain sectors (notably for hospital and healthcare schemes), the Treasury view is that where PFI is appropriate, it should be used. Limiting the number of acute hospital schemes undertaken as PFI projects on some sort of "arbitrary fairness principle" is simply misguided.

A look at the accounting treatment of PFI shows that 57 per cent of PFI projects are treated as on-balance sheet items, 43 per cent as off-balance sheet (Figure J). Again, the argument that government is pursuing PFI to keep debt off its balance sheet is not correct. Nor is

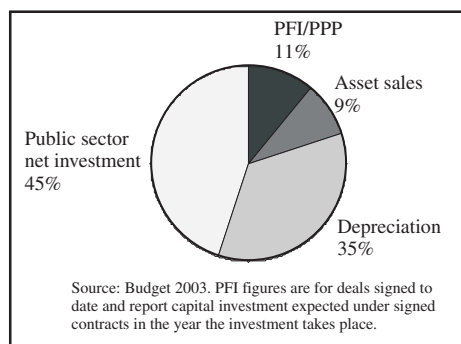


Figure I PFI investment as a proportion of total investment in 2003/4

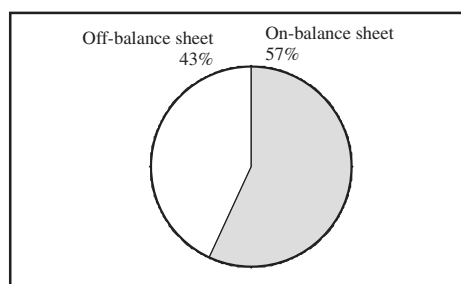


Figure J Balance sheet treatment of PFI projects by value

the view that we are mortgaging our future through PFI. Future unitary charges to PFI contractors are unlikely to be a significant factor in government finances and will probably amount to £5 billion or £6 billion at their peak in any particular year, not a huge sum in terms of total expenditure (Figure K). Excluding the London Underground contracts, which are large and atypical, the value of PFI transactions is expected to rise over the next two or three years. A large part of the PFI expenditure will be allocated to the secondary school modernization programme.

It is too soon to judge whether PFI projects provide value for money operationally, but the case for PFI offering better solutions for construction has been convincingly made and the Treasury believes that PFI clearly provides a better outcome for construction. On the question of employees' terms and conditions, the government wants to modernize working practices in the public service but not at the cost of lowering them. In order to protect terms and conditions in the NHS, for example, the "retention of employment" model has been introduced to cover the provision of soft FM. Nonetheless, the government wants to take forward areas where the private sector can bring good management practice, better training and specialized services. The aim underpinning the government's approach is to achieve greater flexibility.

On strategic and management procedures, a new appraisal process is proposed in the document, to ascertain whether PFI is appropriate and offers value for money. The process will comprise three stages: investment programme assessment, public-sector-comparator assessment and final procurement assessment.

Government intends to continue with PFI for major projects such as schools, hospitals, transport and defence. However, the past practice of using PFI for smaller projects will be curtailed. To date, around 70 per cent of PFI contracts (by number) have been worth under £20 million. Individually procured projects with a low capital value are disproportionately expensive. Smaller PFI schemes will now be limited, although deals could be bundled or perhaps centrally procured.

PFI might be extended into new areas, such as new-build social housing (although PFI pilots in housing have not been very successful) and urban regeneration, as well as offering more opportunity in correctional services and the prison estates. Other PFI topics coming up for review are the central guidance on bid evaluation, the mooted standardization of contracts and accreditation of professional advisers, the case for increasing the equity capitalization of PFI schemes on a mandatory basis, reform of the Spens clause (i.e. a termination payment to compensate bondholders where the government terminates a project voluntarily) and financing techniques (i.e. framework funding, credit guarantee finance and hedging).

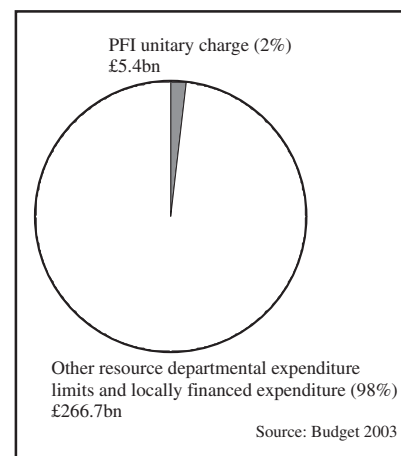
Although the government is broadly satisfied with PFI, its priorities now are to ensure the future flexibility of PFI, the long-term viability of the special-purpose vehicles and a good understanding among public sector clients of what value for money really is.

## Seventh Discussion

The discussion covered macroeconomic considerations on investment in PFI projects, the need to show the project community that PFI contracts were not always being awarded to the lowest bidder and proposals for an "alternative debt mechanism".

### Procuring PFI Projects in the Ministry of Defence (Mike Cooper)

The Allenby/Connaught project is concerned with providing working, residential and technical accommodation on six sites, largely as a result of troops being brought



**Figure K PFI unitary charge payments in 2003/4 as a proportion of departmental and locally financed annual resource expenditure (£bn)**

- 15,700 military and 2,100 MOD civilians on six sites
- 10,700 single living bedspaces
- Technical accommodation for 1,400 A vehicles and 4,200 B vehicles\*
- Approximately 1.3 million m<sup>2</sup> of building space
- Total capital value circa £1bn
- Annual service costs circa £100m

\* A vehicles = armoured vehicles, e.g. tanks  
 B vehicles = lorries, Land Rovers, etc

**Figure L The Allenby/Connaught project: facts and figures**

out of Germany by 2005. Some of the army infrastructure is decades old and does not meet modern expectations. The provision of single rooms with en suite facilities is important in helping to recruit and retain soldiers and will entail huge investment. High-quality support services will have to be secured. Long-term value for money and a smooth transition are priorities.

This is a mega project, involving 15,700 military personnel and 2,100 MOD civilians (Figure L). The total capital value is £1 billion, annual service costs £100 million.

MOD is a regular user of the PFI model. Where will PFI be going in the future? Projects fall broadly into three groups: the smaller “commodity” projects (mainly repeat projects worth less than £50 million), bespoke projects (mega, one-off deals, worth over £500 million) and projects occupying the middle ground. All three groups could continue to be done under PFI in the future, though each type requires a particular kind of discipline and management.

One of the issues for the future is whether projects being procured or services being restructured are best tackled on a horizontal or a vertical integration. Assets and services could be provided vertically, for one particular site (e.g. a garrison) or horizontally, across sites (e.g. a water and waste water services contract in MOD’s Project Aquatrine). Opinions are strongly divided here. By slicing up the requirements horizontally, economies of scale could be achieved, but multiple interfaces are created.

The uncertainty of bidding costs and timescales, which often escalate, poses a real problem for the major project community. Clients have to set out realistic timetables and processes and stick to them. The public sector comparator hovers like a spectre during the bidding process and its intrinsic value, in its present form, has to be questioned.

There is an absence of cooperative strategic planning for PFI projects, even where different departments or authorities have similar requirements in the same geographic area. Perhaps a central planning department across the whole of government is needed or the Office of Government Commerce might have a contribution to make. In equipment procurement, MOD is forecasting 10, 15, even 20 years ahead, which is a help to the defence industry; in PFI, equally, better information should be given to contractors. Future questions for PFI include standardization of contracts, the scope of future projects, controlling bidding costs and time to bid, and getting a sensible flow of projects on to the market.

## **Eighth Discussion**

The discussion covered the lack of centralized procurement (prevented by English constitutional arrangements), the likelihood of interdepartmental cooperation (theoretically possible) and situation in the devolved territories, Scotland and Northern Ireland.

## **Summary and Conclusions (Jeff Zitron and Sir Alan Cockshaw)**

Jeff Zitron, who was responsible for the Henley report, PFI and PPP Projects – Are They Working?, gave a summing up. Are PFI/PPP projects working? The answer is yes: they are delivering projects and services faster and within budget. A more positive engagement between the public and private sectors is being forged. There are reservations, of course, notably the public sector’s shortcoming as a client and the

lack of full information about deal flow that would help contractors. The NHS appears keen to find a route to effective route to procurement: if that is PFI, so be it. But there are boundaries to the appropriateness of PFI. It is to be discontinued for IT projects. Where “whole-service” PFIs are not suitable, the interfaces between the public and the private sectors have to be well handled. PFI offers synergies that lead to improved buildability, reliability, operability and risk transfer, although in the future the lack of sufficient flexibility in some PFI schemes may be felt.

Sir Alan Cockshaw added his own conclusions, underlining some of the highlights of the conference. PFI is likely to grow over the next few years, thanks to the investment needed in certain areas, such as secondary schools. It has already brought much to the hospital sector. The government is seeking to remedy the weaknesses in PFI and introduce improvements. Even if the jury is still out on the operational success of PFI, the presentation on the use of PFI in prisons impressed. Industrial relations need careful management. The focus on the financial aspects of PFI is sometimes excessive and, as one presenter argued, PFI might have been more wisely named the Better Procurement Initiative. The delivery of capital projects under the PFI has been tried and tested, and the future for PFI schemes is bright, provided that the need for continuous improvement is accepted.

*Acronyms explained*

FM facilities management  
DBFO design, building, finance and operate  
DWP Department for Work and Pensions  
KPI key performance indicators  
NAO National Audit Office  
PRIME PRIME is the Private sector Resource Initiative for the Management of the Estate, a property agreement between the DSS (now DWP) and Land Securities Trillium.  
SPV special-purpose vehicle

