

P&SM: Private Finance Initiatives



A means of bringing together the public and private sectors to work together in long-term partnerships which best utilise the assets and skills of both sectors, with the aim of creating better value for money for taxpayers.



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Introduction

The CIPS' practice documents are written as a statement in time. They are a collection of views on good practice within a particular subject area and are intended to provide direction on good practice with some guidance for context and interest. The reader is encouraged to use the CIPS practice documents for their own purposes, such as writing policy statements, guidance or procedures. This particular practice statement has been written primarily for the benefit of full-time purchasing and supply management professionals, but can be used by anyone associated with, or interested in, purchasing and supply management (P&SM).

This document is about private finance initiatives (PFIs).

Definition

Public Private Partnership (PPP) is a means of bringing together the public and private sectors to work together in long-term partnerships which best utilise the assets and skills of both sectors, with the aim of creating better value for money for taxpayers. PFI entails transferring the risks associated with public service projects to the private sector, in part or in full.

There are a number of different forms of PPP, including PFIs. Other forms of PPP include strategic service delivery partnerships, joint venture companies and arrangements where private sector skills are used to sell public sector services and assets into a wider market. The key distinction between PFI and other forms of PPP is the use of private sector finance and the length of the contracts involved. PFI is typically used for capital intensive projects.

In comparison with the privatisation of public assets and services, PPP is often referred to as being more like a merger than a takeover, with both sides sharing the risks and, hopefully, seeing the benefits. For more information, please refer to the CIPS position on practice on public private partnership, which is also available on this site.

Background

Rarely out of the headlines on costs, PFIs attract a wide range of views and emotions from Government service recipients, providers, trade unions and the general public. They are seen by some as a cost effective, efficient way to deliver public services and by others as inappropriate and expensive, being driven by the lack of public finance to the detriment of public service. Many PFI projects have subsequently been determined as lacking value for money and expensive by auditors such as the National Audit Office (NAO).

In traditional major project procurement the public sector raises the capital to finance the build (or infrastructure provision), the private sector bids for a contract to build, and once build is completed, the facility is handed to the public sector to maintain and run.

PFI is an alternative procurement vehicle by which public sector bodies can provide major capital projects and associated services such as hospitals, schools and roads without raising the capital. In a PFI project, the private sector finances designs, builds, and operates an asset and associated services. In return, the private sector receives an annual payment linked to service performance. PFI contracts are long-term, typically lasting 25 or 30 years. At the end of the contract period the facility generally belongs to the public sector.

Explanation

PFI's are seen by their advocates as a way of ensuring that the public sector does what it does best: policy and long-term planning, whilst the private sector uses its skills to finance and deliver the plans.

A key feature of PFI's is that they give a greater opportunity to pass ownership of risk from the public to the private sector if successfully negotiated at the project initiation and contract stage. For example, a building may be designed and built in such a way that it requires a high maintenance cost for years to come to keep it up to standard. Traditionally, this cost would have to be borne by the public sector client. Under PFI the private sector would be responsible for the on-going maintenance and upkeep of the building. This contributes to an increased focus on the whole-life cost of the project.

The risk of non-performance of the asset will also sit with the private sector as payment mechanisms are linked to performance. The temptation to "build cheap, run expensive" should be negated by PFI's. Additionally, in PFI's, payment doesn't start until the facility is operational which gives a huge incentive to the private sector to complete on time, mitigating somewhat the risk of the facility being delivered late.

CIPS believes that, as a general principle, the mitigation of risk should sit with the party best able to control it. However, the ownership of risk is not transferable as, if the risk occurs, it will impact on the business regardless of who is attempting to mitigate the risk.

The identification and allocation of risk requires an honest and open dialogue between the parties, as there is a cost attached to risk. An attempt to place risk with the private sector that is not understood and/or cannot reasonably be controlled by the private sector will attract price loading. It is essential that the public sector buyers and their team have the necessary levels of expertise, at least at the level of technical knowledge and risk assessment, which is necessary to lead to a successful conclusion and contract.

Impact on P&SM Professionals

PFI offers both opportunity and threat to P & SM professionals. On the one hand, there is the opportunity to have influence, profile and impact in a key area of public sector expenditure. On the other hand is the potential to be left behind and, at best, only be involved in the administration of the process.

To maximise P&SM impact on PFI procurement it is paramount that early engagement with stakeholders is achieved, as in all procurement situations. Recognition of P&SM's role in the project management and governance structure should be aimed for to establish P&SM's "right" to input. Influence should start at the option appraisal and after the project preparation stage, when the decision to proceed with a PFI or another form of procurement is made.

CIPS believes that the high value and long-term nature of PFI contracts requires increased focus, rigour and application of procurement tools, such as whole life costing, robust governance models, risk management processes, contract change mechanisms, dispute resolution processes and a shift from input to output specifications. There is evidence that this increased focus is now being applied to general procurement, giving the P & SM professional, skilled in the application of such techniques, an increased opportunity to raise their profile and impact.

A recurring theme in PFI contracts is the difficulty that contract managers and others involved in the operational phase have in understanding and interpreting the contract and limiting future charges. PFI contracts are, by their nature, complex and have to cover a wide range of requirements, payment mechanisms and eventualities. It is common for there to be little, if any, crossover between the team who take the PFI to financial close and the team responsible for contract management. This can create unnecessary project delays caused by needless misunderstandings.

To avoid this situation the P&SM professional should seek to ensure that there is sufficient clarity in the contract and that it is written at a level that those involved can understand. It is beneficial, therefore, if there is crossover between the two phases so that the P&SM professional can make a contribution by assisting the contract management team in ensuring that there is a practical understanding of the contract terms.

The National Audit Office (NAO) has identified a lack of public sector commercial knowledge in PFI deals¹, both in the negotiation of the original contract and in the negotiation of contract variations and re-financing deals. This criticism is levelled at all the disciplines involved and not purely P&SM professionals. It does, however, represent an opportunity for the profession to up-skill and develop a body of knowledge on PFI. Some local authorities, such as Leeds City Council, have established Public Private Partnership Units to provide advice across all of the authority's PFI projects, rather than dealing with each PFI in isolation.

PFI payment mechanisms are linked to performance measures set against output and outcome specifications, which in some cases have not controlled or limited charges. It is crucial that the P&SM professional involved in PFI has a thorough understanding of defining and applying this type of specification, and of associated performance measures, to ensure that the PFI contract delivers or exceeds the required service requirements.

To assist authorities in contracting for PFI projects HM Treasury has produced a standard contract with guidance notes². In addition there are approved sector specific variations such as social care.

Issues

Given the long-term nature of PFI contracts, the effectiveness or otherwise of PFIs in the UK cannot yet be judged over the full life of the contract. However, there are a number of emerging issues that are of interest to the P&SM professional:

a) Maintaining bidder interest in PFIs is emerging as an issue and there are signs that the number of interested bidders for each PFI project is declining. Declining interest is partly due to the lengthy tendering processes prevalent in PFIs (on average 34 months³) and high bid costs. Some of the reasons for delays to PFI tenders that have been identified include: lack of agreement and commitment from stakeholders, variations to the specification and a lack of public sector experience in managing complex PFI projects. Additionally, as public sector expertise improves profit margins will reduce making PFI schemes less attractive to potential contractors.

¹ http://www.nao.org.uk/publications/press_notice_home/1012/1012920.aspx

² http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm

³ http://www.nao.org.uk/publications/0607/improving_pfi_tendering.aspx

b) A lack of capacity in the market is an emerging issue. Whilst PFIs enable projects to be started, that would otherwise be in the funding pipeline, there is a possibility of flooding the market with projects without a corresponding increase in market capacity.

c) Refinancing is a high-profile issue. As the PFI market has become more established, there is potential for improving the financing of a PFI. This is because the financial risk in a successful PFI decreases as it goes through the service delivery phase. Additionally, the PFI market is becoming increasingly mature and viewed as lower risk than when many PFIs were originally financed. However, there have been concerns that the public sector has not always received its fair share of the benefits from refinancing.

d) As PFIs are increasingly funded through complex financial packages, they are vulnerable to mergers, acquisitions, rising and falling financial markets, bankruptcy and changing corporate objectives. Changing partners may lead to relationship issues and questions around the commitment of new parties to the original aims and objectives of the project.

Conclusion

PFI and other forms of PPP will remain an important procurement vehicle for the public sector in delivering services to the public. There is an opportunity for P&SM professionals to play a key role in the delivery of PFI. However, there is a need to ensure, along with other professionals in the public sector, that skills and knowledge are developed, retained and shared.

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