



What is a Public Private Partnership (PPP)?

A PPP project generally involves the design, construction, financing and maintenance and in some cases operation of public infrastructure or a public facility by the private sector under a long term contract.

A PPP project may be a "financially free standing" project where the PPP contractor receives its revenue from the use by the public of the asset provided, like the use of electronic tolling systems on highways. In the case of social infrastructure projects such as schools and hospitals, the government will pay the PPP contractor for the delivery of the service provided by the contractor.

For a government to consider a PPP as an alternative means of procuring public infrastructure or facilities, the PPP route must be demonstrated to offer better value for money than traditional public sector procurement. In addition to comparing the cost of design, construction and maintenance by the private sector to the cost of procurement by traditional public sector methods, additional factors such as risk transfer, innovation, increased efficiencies in design, construction and operation and whole-of-life approach to the provision of the facility will be taken into account.

The focus of a PPP project will be on "outputs" and the delivery of a "service" rather than the construction of a building. Where payments are to be made under a PPP contract, they will be based on the delivery of a service which meets the performance requirements of the output specification. To provide incentive for compliance, the PPP contract will have mechanisms for payment deductions where the "service" is provided below the level required.

Forms of PPP

PPPs can take different forms:

- Contracting out or management contracts – where the private sector is only partially involved, for example it provides a service or manages without taking any risk;
- Joint ventures – where the private and public sector jointly finance, own and operate a facility;

What are the main differences between project finance and PPP/PFI?

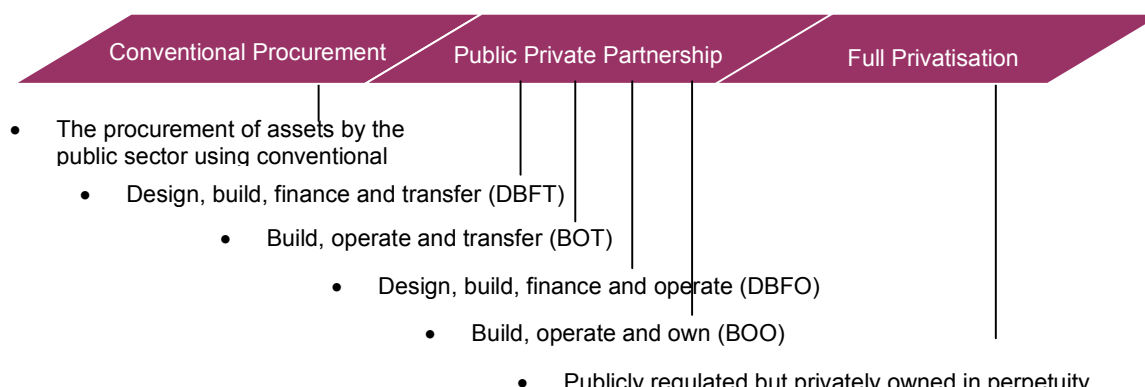
Project finance refers to the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cashflow generated by the project. Project finance is used in a variety of sectors such as power, oil & gas, transportation and infrastructure.

Private sector companies use project finance as a means of funding major projects off balance sheet thereby enabling companies to invest while keeping their levels of book debt low as project finance transactions are not treated as company debt. Central to any project finance transaction is the Special Purpose Vehicle (SPV) which consists of a number of shareholders who are involved in the transaction and will be called upon to serve a function in the project at a specified time during its lifetime i.e. a consortium will normally consist of funders who will be required to invest money into the project, a construction company who will normally act as the principal contractor.

PFI differs to project finance in that the government or local authority is always the main buyer of the specified service/asset and the project is dependant on the public sector to repay private sector debt used to finance the project's construction or modernisation.

- Leasing – where part of the risk is transferred to the private sector;
- BOT (Build Operate Transfer) – where the private sector takes primary responsibility for funding, designing, building and operating the project. Control and formal ownership of the project is then transferred back to the public sector. Possible variations on this theme can be BOOT (Build Own Operate Transfer); DBFT (Design Build Finance Transfer); DCMF (Design Construct Manage and Finance); BLT (Build Lease Transfer); DBFO (Design Build Finance Operate) and many others;
- BOO (Build Own Operate) – where the control and the ownership of the projects remain in private hands.

Figure 1: Asset Procurement Options



Source: IFSL



PPP Contracting Structure

The PPP project will generally involve a public sector department or body developing a project brief and output specifications and inviting bids for the project from short listed tenders. A tenderer for a PPP project will also generally be a consortium, possibly lead by a contractor with other members of the consortium that may consist of lenders, specialist contractors and possibly other service providers providing equity for the project.

Figure 2 below sets out a typical contracting structure for a PPP project.

In this contracting structure the consortium will have a long term PPP contract with the public sector body of 20 to 30 years in length (sometimes referred to as a "concession"). The successful consortium will set up a company, known as a "special purpose vehicle" (SPV) to be contracting entity. The SPV will then enter into subcontracts and pass through the risks and responsibilities for providing various aspects of the services to subcontractors. In relation to facilities management there is likely to be a mix of "hard" and "soft" services, with the FM services provider being responsible for some hard services, such as routine building and equipment maintenance, and generally for a range of soft services that may include services such as cleaning, waste, security, catering, landscape maintenance and similar services. The structure of a PPP project has been designed to encourage an integrated approach to the design, construction, financing and operation of buildings and other assets so that issues such as maintainability, durability and operability are addressed at the outset of projects.

The PPP contract may require periodic "benchmarking" or even "market testing" of aspects of the services being provided, such as facilities management.

What is the difference between PFI and PPP?

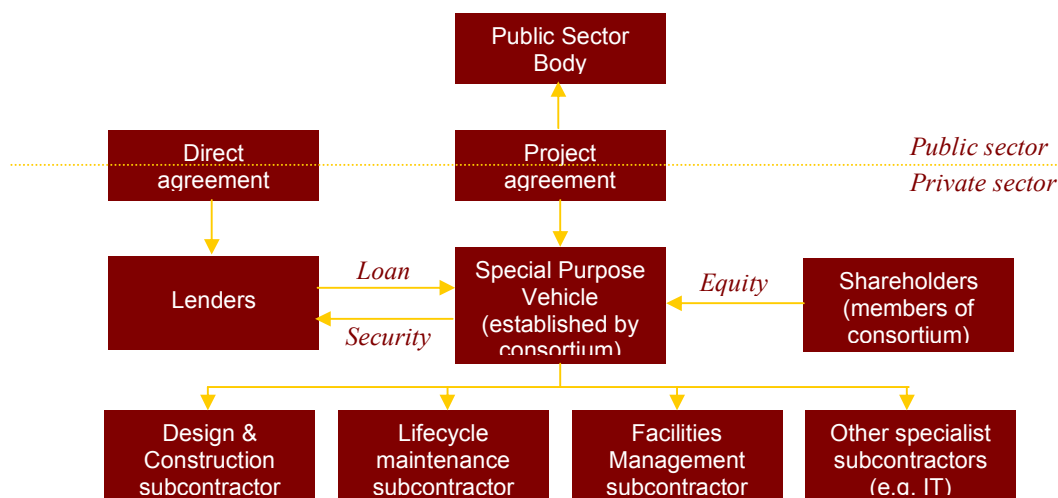
The term "PPP" is used to describe wider public private joint ventures and initiatives which may not solely rely on government revenue streams as the sole source of repaying bank debt taken out to finance a service or asset or may not require asset finance at all. PPP's are a generic term which can involve the private sector taking a majority stake in a public agency.

PPP in Europe

In the last few years there has been a growing interest in PPPs in Europe. Across Europe, governments and local authorities are investigating how the concept of PPP might work in their markets, while construction companies, legal consultants and other economic agents are seriously considering the possibilities offered by PPP techniques.

One of the most efficient models seems to be to appoint one centralised government office to facilitate privately financed infrastructure projects. Many countries – like UK, Ireland, and Italy – have established PPP Units. By contrast, countries, like France and Spain, have a history of cooperation between the state and the private sector; the governments own assets and give to a private sector agent a concession to operate the asset. Even if it is not possible to identify a common European PPP model, the value of Public Private Partnerships appears to be increasing across Europe.

Figure 2: Typical contracting structure for a PPP project





The Dutch, the British and the French experiences are significant examples of possible PPP approaches:

- The **British** government launched a PPP development policy in 1992 by creating the Private Finance Initiative (PFI) in order to encourage private investment in infrastructure and social services. It has also established a Treasury Taskforce, based inside the government, and has given it the responsibility to support the public sector in negotiating PFI projects.
- The **Dutch** PPP Directorate at the Ministry of Finance, was created in January 1999 in order to meet the Government needs to better organise itself as a partner for the private sector. Shortly after one major pilot project was started (the high speed rail) and the project had received an international award as a prime model of a PPP structure. The current list of projects includes road, railway harbours and water projects.
- The **French** model differs from the British and the Dutch. The French government has not launched an official Public-Private Partnership development policy nor has it established any formal PPP unit. This is due to the fact that PPPs are considered an “old concept”. The French PPP model goes back more than a hundred years in the form of Sociétés d’Economie Mixtes and Concessions. PPPs are not an instrument permitted in the social infrastructure areas.

Other developments in other European countries are:

Croatia

There is no single authority assigned to deal with PPPs, but the Government’s strategy is positively oriented to the use of BOT schemes for the construction of motorways. Also in other sectors PPP schemes are being applied such as the energy sector (Lukovo Sugarje) and the water sector (Central Waste Treatment Plant for Zagreb).

Germany

Germany has no formal central government PPP unit or program, although it has in the past involved private sector contractors in road projects, some of which did involve risk transfer to the private sector under a concession framework. A BOT law has however been passed recently.

Ireland

Ireland has a history of co-operation between public and private sectors. Over the last decade toll bridges, government offices, prisons and waste management facilities have been designed, built, financed and operated by the private sector. Today, there is a strong public commitment to a formal PPP program. A clear legislative framework is in place, a dedicated PPP unit has been set up in the Department of Finance and there are central committees designed to push PPPs forward.

The Irish administrative structures for PPPs is based on the interaction of five different elements: the above-mentioned central PPP Unit in Department of Finance – the interdepartmental Working Group on PPPs (IDG) – the Public/Private Informal Advisory Group on PPPs (IAG) – the Cabinet Subcommittee on Infrastructure.

Is PFI another form of privatization?

Privatisation involves the complete transfer of a public asset or service into the private sector where the private sector has complete control over how the service/asset is operated. The asset/service is wholly owned by the private sector. PFI differs in that the public sector retains a degree of control over the asset/service by dictating what performance targets or outputs the private sector must reach in order to receive a fee in return. The public sector has ultimate control over a PFI scheme and can step in and take back the concession if the private sector fails to deliver the promised services. Whereas in full privatisation, the public sector has no control (unless a regulator is established to set tariffs) over the management of a service in the private sector i.e. Railtrack. A PFI scheme allows the private sector to apply private sector management expertise, but the public sector has the ultimate control. The asset/service is only in private sector control for a specified time period (concession) upon which ownership reverts back to the public sector unlike full privatisation where ownership is in the private sector indefinitely.

Italy

A legislative reform of the Public Works Framework Law (Merloni Law) in 1998 set the framework for using private sector contractors and incorporated provisions on Project Finance. More recently a special PPP taskforce - Unità tecnica Finanza di Progetto (UFP) - was set up. The 2001 Finance Act has reinforced UFP powers. According to the 2001-2004 Economic and Financial Planning Document: “the Government expects to finance through private funds Euro 9 billion of new infrastructures”.

Portugal

Although there is no central PPP government unit Portugal was an early exponent of PPP in western Europe with the Tagus Bridge in Lisbon and other road projects. The Ministry of Public Works has developed the SCUT program to build the country’s road infrastructure. Under this program, 3 toll roads have already reached the financial close and one has already been syndicated. Around a dozen other road projects are being implemented. The Government is promoting PPP not only for large-scale projects (i.e. motorways, railways, airports, and water) but also medium sized infrastructure projects (i.e. parking, subways, local transportation, and museums) and is now looking at opportunities in the health sector.



Romania

The Romanian Government is exploring a few PPP projects. The use of concession-based financing techniques is being currently examined to build 11 sections of motorways along the corridor from Bucharest to Constanza. On 14 April 2000, the French utility company Vivendi was awarded a twenty-five year concession to provide water and pipeline rehabilitation services to Bucharest. It is estimated that Vivendi will spend about 1 billion USD over the entire life of the contract to construct a new treatment system and to modernize the existing water system.

Spain

Spain has not established a formal PPP unit. However, the government has a road program similar to that in Portugal, using the shadow toll structure. The state rail company, RENFE, is expected to invite private sector involvement in 3 new rail lines and other initiatives. PPP projects are also planned in the health and waste management sector. Practically all- financing methods are available in Spain: long term agreements, shadow tolls (particularly used in Madrid and Murcia region), and deferred payment of price.

Finland

Finland has completed several PFI deals, including the Helsinki-Lahti DBFO road project, which was widely acclaimed as a success, and the Espoo sixth form college. After a quiet period there is interest in developing PPPs in defence and health sectors.

Key Challenges for Europe

Notwithstanding the positive commitment in Europe towards PPPs, there are still obstacles that have to be overcome, particularly in the PPP market of the transition economies, in order to promote the concept more widely.

High Risk

The perception of high risk attached to lending on project finance in Southeast Europe is difficult to overcome. It deters the private commercial banks from lending to the region. Risk is made up of several components (i.e. political, commercial, price etc) some of which can be covered by international financial institutions. In this context, country credit risk is also an important factor. Private commercial banks are frequently reluctant to enter Southeast European markets due to the general legal and regulatory weakness that characterise these markets. However, as many economies are improving in economic terms (i.e. Poland), real PPP opportunities will develop. In the medium term as the Southeast European countries' economies will progressively develop, the PPP market will grow.

Lack of Legal Framework

In many countries, there is no legal framework for PPPs. Ideally a robust system of commercial laws needs to be in place. The private sector interests have to be protected under the existing laws. Government agencies have also to

facilitate the involvement of the private sector in infrastructure projects or public utilities.

Key Drivers and enablers for PPP

Drivers

- Financial need
- Poor infrastructure
- Demands in public sector services
- Search for efficiency and creativity
- Desire to introduce competition
- Scarcity of domestic experience
- Desire to educate national contractors
- Bandwagon effect

Enablers

- **Political framework:** political will or commitment
- **Legal framework:** documentation not excessively complicated
- **Public acceptance:** acceptance of private sector involvement
- **Quality practitioners:** experienced project sponsors

Capacity and skills of public administration

Most importantly of all, the capacity and skills of public administrations have to be improved to manage and negotiate successful projects. PPPs should be promoted and used in the reconstruction of South East Europe. This should be a number one priority. In this context, bringing the PPP Units and interested government departments into a regional network would improve the governments' capacity to facilitate projects.

Authoritative, central government commitment.

The PPP Units are the best manifestation of this commitment. Ministerial responsibility is given for the creation of the PPP Units and across government or central units such as the UK Treasury Taskforce and the Netherlands Kenniscentrum. Their roles typically define and develop best practice, structure policy development and provide guidance to PPP project teams. The setting up of dedicated PPP Units or Task Forces all over Europe has mobilised the public administrations behind PPPs giving them high- level political sponsorship.

Willingness to implement necessary legislative changes.

In most, if not all countries, where PPP program and PPP Units or similar bodies have been established, changes to the law have been necessary to create the right environment for projects to flourish. Areas, which typically need attention are:

- Establishing or clarifying the legality and powers of public authorities to enter PPP style contracts (one of the main challenges faced by governments in transition economies is to identify the agency or ministry that has sole negotiating authority for concession projects);



- Removing tax anomalies which can weigh against PPP approaches;
- Refining public expenditures capital control regimes to accommodate PPPs.

Identification of, and commitment to, a pilot project program.

Establishing working examples of PPPs rather than theoretical models as early as possible is essential if the confidence and trust of public sector procurers and private sector bidders is to be established. Given that the expertise for PPP concepts will typically be scarce at the outset of a program, focusing such resource on a small number of representative projects, such that each is well served, is likely to be the most effective approach for the long term commitment and sustainability of a PPP Program.



Lessons from the UK

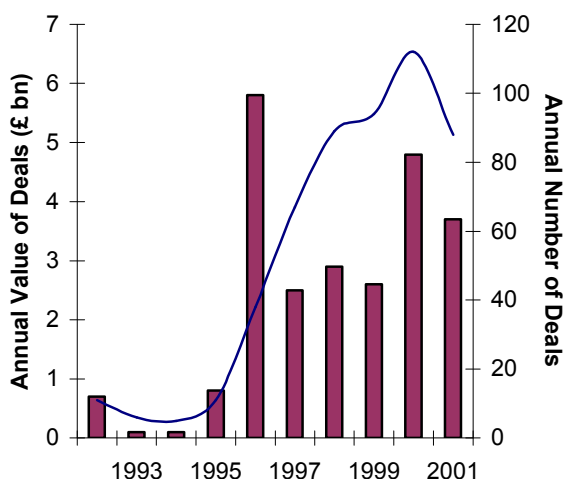
As we have seen the UK is one of the most mature markets in the field of one particular PPP scheme, namely PFI. Therefore it is useful to analyse how PFI has developed in the UK and what are the experiences so far. The UK model in the form of PFI may also be appropriate for other countries, but even where not, serves to illustrate key benefits and lessons.

An overview

During the 1970s and 1980s, the concept of public private partnerships for public infrastructure saw development under BOOT, BOT, BOO and similar arrangements. Build, own, operate and transfer contracting arrangements were used on a number of major infrastructure projects in both developed and developing countries around the world.

Then, following a period of public sector asset and utility privatisation, the UK Government introduced its Private Finance Initiative (PFI) policy in 1992. The PFI was designed to promote the use of private sector expertise and finance in public sector infrastructure projects. PFI was introduced in accordance with the philosophy that greater economic efficiency and lower costs could be attained by "contracting out" the provision of services traditionally arranged and provided by the public sector.

Figure 3: Signed PFI deals in the UK

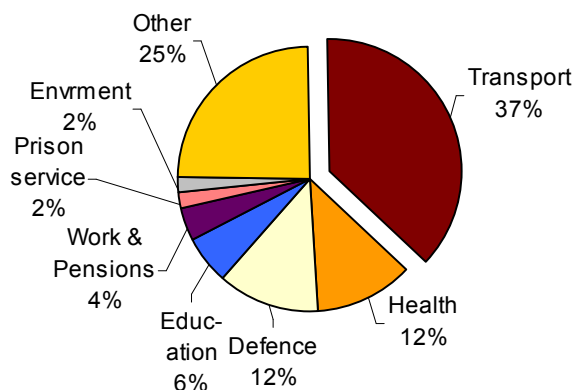


Overall, PFI projects totalling £24bn have been signed since the early 1990s. Of this total, over two thirds, some £17bn, have taken place since 1997 following the removal of barriers to PFI-type schemes (figure 3). Projects commissioned by the Department of Transport accounted for over a third of signed deals, with the Health, Defence and Education departments also prominent (figure 4).

Altogether, over 530 contracts on PPP projects had been signed by July 2002. Initially, the overall value of deals was heavily influenced by some very large schemes, such as the

£4bn Channel Tunnel rail link in 1996. However, the rapid growth in the number of signed deals since 1997 demonstrates how PPP has taken off at the local level in the UK. 67 contracts were signed in 1997 alone, more than in the entire period up until then. Since then over 80 deals have been signed each year.

Figure 4: PFI deals in the UK by cumulative value of signed deals up to July 2002 by Government department (%)



Before we will go into specific evaluation items on PFI deals in the UK, we would like to describe the generally considered advantages and disadvantages of PFI schemes so that we can compare them later on with the findings.

Advantages of PFI

- Value for money : Synergies from combining design, construction and operation**
 While there is an additional financing cost for the use of private sector funding, this should in many cases be offset by the synergies gained from combining design, construction and operation. This should contribute to a reduction in operating costs, an enhanced level of service, and the benefit gained from the transfer of risk to the private sector. Private finance and operation will usually avoid the costs and timetable slippages that have been common under traditional public procurement. This approach encourages bidders to focus on the whole life costs of the asset over the project life cycle because those responsible for the building of an asset are also responsible for long term maintenance and operation.
- Detailed risk analysis and proper risk allocation**
 In PFI schemes, the participants are obliged to consider risk assessment and proper risk allocation, which are not practised in conventional procurement. By identifying risks *a priori*, and planning for their mitigation up-front, some project difficulties could be avoided.



- **Advancing Facility Management (FM) services**
In a traditional procurement scheme the client retains the operational risks, which leaves the FM professionals with very little scope for risk taking and initiative. PFI should give to the FM providers greater responsibility and should upgrade their role to complete service provision and property development.
- **Faster project completions**
Delays in PFI projects should be reduced due to the incentive packages and heavy penalties, which are imposed on the private sector companies.
- **Cost escalations are curtailed**
In PFI the risk of cost increases is transferred to the private sector, which can use best practice solutions to manage it.
- **Innovations are encouraged**
PFI should enable the private sector to introduce innovative solutions in design, construction, and service delivery, instead of one solution being imposed by the client.
- **Maintenance costs are adequately accounted for in PFI**
Public sector clients have a mechanism assuring that the asset will be maintained in the long-term, according to pre-determined standards. Projects are planned, not only in respect of the immediate future, but for periods of 25- 30 years.

Disadvantages of PFI

- **High cost of PFI procurement**
One aspect of the high costs concerning PFI is the tendering process. Some clients have to rely, sometimes heavily, on professional advisors. Private companies have reported spending millions in putting up bids, which they are not guaranteed to win. In the worst scenario bidders come second, and thus incur the full bidding costs without winning the deal.
- **Lengthy and complex negotiations**
These can stretch for more than two years, involving a great number of parties, sometimes resulting in what some participants have described as 'bidding fatigue'. Due to the lean structure of private sector companies this is considered to be an inefficient use of resources.
- **Difficulty in specifying the quality of a service compared to specifying an asset**
Sometimes the precise definition of a high quality service may be elusive, which allows different interpretations and can result in post-contract disputes.
- **Pricing the FM services in a vacuum during the bidding stage**
This can be due to the very fluid design, and other information, on which to price the operational and maintenance aspects.
- **Potential conflicts of interests**
These could arise between different participants as they are looking at the scheme from different perspectives. For instance, the consultants in the projects may offer different or conflicting advice, since

their concern is to satisfy the particular party engaging their services.

- **Smaller firms cut out**
It is difficult for smaller firms to access the market because of the potential high cost of failure, the large size of projects, lack of appropriate skills and lack of credibility in the marketplace.

Most PFI contracts are still in their early stages and none of the contracts have run through the entire exploitation period of usually 25-30 years. Conclusions are therefore premature, but do give insights in the current bottlenecks. The following items will be discussed:

- Partnership performance
 - Value for money for authorities
 - Authority and contractor relationship
 - Authorities' monitoring of contractors' performance
 - Understanding each other's business
- Procurement process
 - Cost of procurement
 - Negotiations
 - FM services
- Financing
- Risk allocation
- Construction performance
 - Price certainty
 - Timing of delivery
 - Innovation
 - Quality of design and construction

Partnership performance

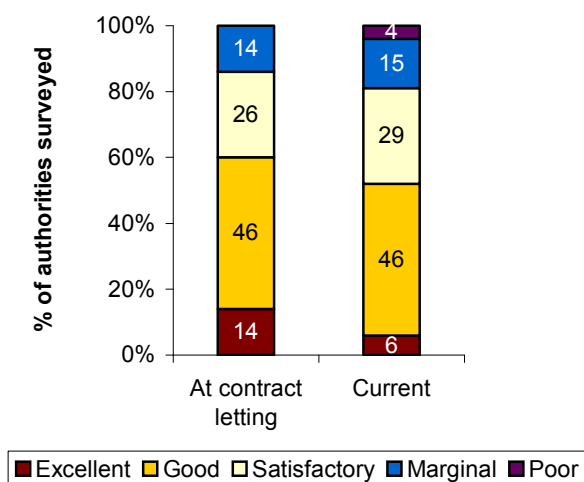
- *Value for money for authorities*

A successful partnership allows the participants to work together to achieve their objectives to their mutual benefit: the public sector receives a service that represents value for money and the contractor delivers that service for a reasonable return.

According to a survey of the NAO (National Audit Office, November 2001) 81% of authorities said that value for money was currently satisfactory or better, 15% said it was marginal and 4% said it was poor (see figure 5).

There has been a slight decline, however, in perceived value for money since contracts were let. Some 86% of authorities considered that the value for money of their PFI projects at the time of contract letting was satisfactory or better, 14% said it was marginal and none said it was poor.

Figure 5: Authorities perception on value for money

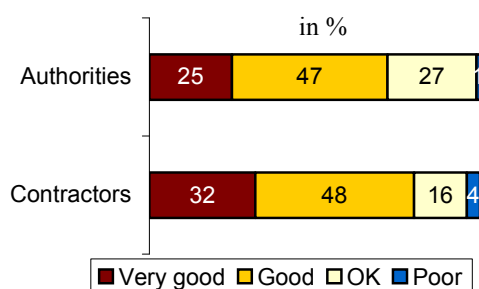


These figures demonstrate the high expectations that authorities have for the success of PFI projects in delivering value for money in public services. But they also indicate that value for money is not guaranteed. Authorities need to ensure that the value for money anticipated at the time of contract letting is delivered in practice. To do so requires careful project management and a close attention to managing the relationship with contractors.

Authority and contractor relationship

The same survey also showed that 72% of authorities and 80% of contractors view their relationship as being good or very good. Very few (1% of authorities and 4% of contractors) consider that their relationship is poor.

Figure 6: Authority and contractor view of current relationships



Some 45% of authorities and 35% of contractors said that their relationship had improved since contract letting. A much smaller number (18% of authorities and 11% of contractors) said that their relationship had worsened. These results suggest that authorities and contractors are making efforts to maintain a good relationship, but that in a number of cases there is work to be done to improve relationships.

Authorities' monitoring of contractors' performance

Authorities need to ensure that contractors are providing accurate and valid performance data. 75% of contractors thought authorities had adopted an appropriate approach to monitoring their performance. Some contractors, however, felt their relationship with the authority had suffered as a result of the authority becoming too closely involved in performance monitoring.

Understanding each other's business

To achieve their respective objectives and work to a common goal with a single business focus, each side needs to understand the objectives and business of the other, and that understanding needs to be gained during the procurement stage of the deal. The survey of the NAO of November 2001 showed that authorities and contractors have made efforts to do that.

Some contractors, however, considered that authorities made little effort to understand their business as they sometimes rely on their advisors to build a relationship and sometimes do not understand that the special purpose company formed to deliver the PFI project is a commercial organisation with business objectives.

Procurement process

Cost of PFI procurement

One aspect of the tendering process is the high costs. Some clients have to rely, sometimes heavily, on professional advisors. Private companies have reported spending millions in putting up bids, which they are not guaranteed to win. According to one private sector respondent, in the worst scenario they come second, and thus incur the full bidding costs without winning the deal.

Negotiations

Negotiations are often lengthy and complex. These can stretch for more than two years, involving a great number of parties, sometimes resulting in what some participants have described as 'bidding fatigue'. Due to the lean structure of private sector companies this is considered to be an inefficient use of resources. Furthermore, it takes up too much senior management time.

These concerns may be resolved as PPP projects become more routine.

FM services

In a traditional procurement scheme the client retains the operational risks, which leaves the FM professionals with very little scope for risk taking and initiative. PFI gives to the FM providers greater responsibility and upgrades their role to complete service provision and property development. On the other hand the pricing of FM services remains very difficult, as the basis on which to base the operational and maintenance aspects is thin.



Financing

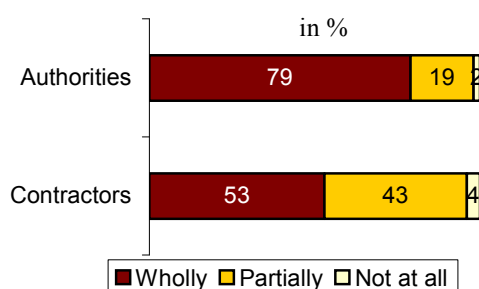
Private finance is typically more expensive than government raised finance but recent competition in the capital markets has seen this narrow as tenors increase, margins narrow and the financial markets learn how to rate a PFI project. Any extra costs incurred by the private sector borrowing funds is more than offset by other factors such as the private sector accepting increased construction risk, management expertise and innovation, increased efficiencies etc. In a typical PFI project, financing costs only account for a third of the projects total costs and each PFI project must pass the 'value for money' criteria that ensures any project carried out on a PFI basis will make a considerable cost saving for rate payers than if it were procured in the traditional manner. In the UK each PFI project must pass the Public Sector Comparator (PSC) test which measures the projected cost savings of a PFI project against a similar benchmarked project procured on a traditional basis. Only when the PFI project is able to clearly demonstrate cost savings against the PSC can the project proceed to the next stage. If at any stage the PFI project fails against the PSC, the project will not be procured on a PFI basis. An Arthur Andersen/London School of Economics study found that PFI made an average project cost saving of 17% when compared to projects procured on a traditional basis, with a predicted £1bn in cost savings for the taxpayer to date.

Risk allocation

Risk allocation between the public and private sectors is a key requirement to achieve value of money in PFI projects. This reflects the principle that value for money will be achieved where there is optimum transfer of risk such that individual risks are allocated to those best placed to manage them. However, if authorities seek to transfer risks which the private sector cannot manage, value for money will reduce as the private sector seeks to charge a premium for accepting such risks.

The NAO survey of November 2001 identified that in some projects there is disagreement between authorities and contractors on whether risks have been allocated to the party best able to manage them. Only two-thirds of contractors shared the authorities' view that risks had been allocated appropriately (figure 7).

Figure 7: Extent of appropriate risk allocation



79% of authorities thought the risk allocation was totally satisfactory but only 53% of contractors had this view.

All contractors who were dissatisfied with the risk allocation thought that risks had been inappropriately transferred to them rather than inappropriately retained by authorities. For example two contractors' views on inappropriate risk transfer:

- For the highway A19, traffic flow risk transferred to the contractor was inappropriate because payment depended on traffic flows which the contractor cannot control.
- For RAF mail the contractor is carrying all of the cost risk. However, the revenue is dependent on the number of users which is not guaranteed. There are variable tariffs to compensate for low use, but very low use will reduce revenue dramatically.

Some authorities may transfer risk back to themselves by telling contractors how the services are to be provided. Authorities sometimes attempted to define the technical solution, or had expectations on how a service should be provided, which limited contractors' freedom to propose alternatives.

In the UK the so called Gateway process was introduced in January 2001, which aims to help to ensure that risks are allocated to the party best able to manage them. The Gateway process will require high risk PFI projects, and all information technology projects, to pass through five gateway reviews at key decision points in the procurement process. These decision points include before the procurement strategy is defined, before tenders from bidders are invited and before contracts are signed. Each of these points will provide incentives for authorities to review the proposed risk allocation and, if necessary, to amend it.

Construction performance

Under a PFI contract the same private sector party, usually a consortium of companies, is responsible for delivering the required service over the whole life of the contract. In PFI accommodation projects, such as hospitals or prisons, the construction element typically represents around 25 to 30 per cent of the total value of the contract. But other project costs, such as maintenance, will be influenced by the quality of the construction work. In theory, PFI incentivises the consortium to:

- estimate the full cost of constructing and maintaining built assets when pricing the contract, as the consortium will not be able to recover unforeseen increases later by claiming them back from the department;
- complete the construction element as soon as possible because the consortium does not begin to receive payments until the asset is ready for use and the service is being delivered;
- achieve good quality construction as the consortium is obliged to maintain the building to agreed standards



throughout the life of the contract, and failure to do so can result in payment deductions or financial damages. This incentive encourages a 'whole life' approach to construction as longer term costs can be reduced by building to higher standards. This differs from traditionally procured assets, where the companies responsible for construction have no interests in the long term performance of the assets.

In theory these are indeed the incentives provided by the PFI approach, but does it also work out in practice? From the latest study of the NAO of February 2003 we can conclude the following:

- *Price certainty*

As shown in the table below 22% of the projects surveyed showed construction related price increase after contract award in comparison with a survey of 2001, where 73% of departments and agencies' construction projects had run over budget for the public sector.

Furthermore, it should be noted that the price increases that occur in the PFI sample were mainly related to further work, which had not been part of the original specification, on additional or improved facilities or changes to the function of a building. Construction cost increases had been mainly borne by the consortium with no increase to the department's payments. Where prices had increased, the survey found that departments had carried out benchmarking in less than half the cases to satisfy themselves that the price increase was reasonable. This is important as such changes take place without competitive pressure.

	2001 Survey on Public works	2003 survey on PFI schemes
Construction projects where cost to the public sector exceeds price agreed	73%	22%
Construction projects delivered late to public sector	70%	24%

The above shows a positive picture for the public sector, but little information is available on the level of rewards to construction companies from PFI works. Besides that the information which is available is rather mixed.

- *Timing of delivery*

The table also shows that 24% of the PFI projects surveyed were delivered late in comparison with 70% of the central government's construction projects surveyed in 2001. Some of the improvement under PFI may be because specifications are often worked out in greater detail and cost and time targets are set later in the procurement process than under traditional procurement. This reduces uncertainty in the process.

- *Innovation*

Although most contractors said their contracts had given them scope to be innovative, some contractors who had high expectations of prospects for innovation found they were less able to be innovative than they had initially anticipated. They attributed this to departments having fixed views on design features or other aspects of how the service should be provided. Most authorities considered their contractors had been partially innovative in taking projects forward.

PFI should enable the private sector to introduce innovative solutions in design, construction, and service delivery, instead of one solution being imposed by the client.

- *Quality of design and construction*

Under PFI, the consortium is obliged to maintain the building to agreed standards throughout the life of the contract, and failure to do so can result in payment deductions. This incentivises the consortium to integrate input from its design and facilities management elements into the construction process.

The consortium considers the whole life cost of the asset, which can lead to higher construction standards in order to reduce the need for longer term maintenance throughout the contract. Higher standards may initially cost the consortium more to construct the building, but will reduce the maintenance costs over the life of the contract. This also reduces the risk of payment deductions due to unsatisfactory service through maintenance failures.

Most public sector project managers surveyed were satisfied with the design and construction of their PFI buildings. They were also mostly satisfied with the performance of the building. However, little information is available from a user perspective. It is known though that overall users feel that procuring departments were putting more emphasis on design quality and aesthetics in more recent PFI projects than had been the case in earlier projects. They felt it was important for departments to make the importance of design quality clear to bidders to emphasise that the department was not simply looking for the lowest cost bid.

Conclusions

None of the PPP schemes shapes an ideal framework for public and private sectors, including the UK model in the form of PFI. However, many problems are being addressed and overall a majority of all those participating in the PFI conclude that it has been good for both the public and the private sector. PFI projects are delivering value for money for the public sector, although this view is more prevalent within the private sector. Furthermore, it is believed that PFI has helped the public sector to procure services that the UK would otherwise have to do without for some time.

Within the private sector there is optimism and much progress has been made in taking forward PPP in the UK. The main concerns remain though that the bid costs remain too high and that the contract award process is often slow and takes much senior management time. Furthermore, it is difficult for smaller firms to access the market because of the high cost of failure, the large size of projects, lack of appropriate skills and lack of credibility in the market place. Also proper risk allocation (excessive risk transfer has been seen in IT projects) and communication between public and private parties are areas which need further attention.

These issues demonstrate that the framework for PPP needs to be continually assessed and developed. Indeed, as the PPP market in the UK is maturing it is likely that new policy priorities will be identified, including:

- Developing new models for sectors which are currently not benefiting from PPP such as primary health centres.
- Improving the framework for dispute resolution within contracts. Main reasons for disputes are:
 - interpretation of the contract;
 - quality of service / output specifications;
 - failure to agree prices for new additional services;
 - delays and missed deadlines;
 - changes in requirement;
 - disagreement over responsibilities.
- Establishing a database which details the results of projects, providing a key source of information to be used in evaluating PPPs.
- Developing policies that are designed to discourage the development of a two-tier workforce. Due to risk transfer a part of the employees are being transferred to the private sector, where different labour conditions are valid. The labour unions were of the opinion that transferred personnel were less protected than in their previous labour environment. Policies need therefore to be further developed. Staff terms are now preserved by TUPE (the Transfer of Undertakings Protection of Employment).

Finally, several British companies are already exporting their experience and knowledge to Poland, Australia and Japan. The market worldwide for the coming 5 years is being estimated on 25 bn pounds.

