

Public Sector : Finance & Control Assignment 1 2019

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Public Finance Initiative



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1.Introduction

The main purpose of this article is to explain the definition of the PFI project and its implementation methods, and to analyse its advantages and disadvantages. At the same time, some PFI schemes are evaluated, and finally the role of audit institutions is discussed.

2.Brief introduction of PFI

Public Finance Initiative(PFI) is defined by the UK Ministry of Finance as: “The public sector purchases high-quality services from the private sector in a long-term agreement or contract, including mutually agreed deliverables, corresponding maintenance or construction of necessary infrastructure”(Kamara 2012), which is a method of funding the public sector and alleviating the burden on governments and taxpayers to raise funds for public projects. The PFI program was first implemented in the UK in 1992 and became widely applied after 1997. They are used to fund major public works projects such as schools, prisons, hospitals and other major infrastructures. (Liu 2009) Instead of funding these projects in advance from taxpayers, private companies are hired to leverage the expertise and knowledge of the company to participate in project financing, design, implementation, and management projects with the government. Depending on various types of projects, the PFI contract can last for 25-30 years, which means that the government does not have to allocate large sums of money to fund the project in a short period of time, while the company make profits through the government's long-term repayment interest.(Akintoye 2009)

3.Operating Mechanism of PFI

First of all, a public sector affiliated with the government should sign a contract with a private company, called a special purpose vehicle (SPV), which is established specifically for the PFI project and is generally composed of several private sector investors, usually including a construction company, a bank and a company that provides operational services. (Nannan Wang 2011) One of the entities, as the holding company, signs the main contract with the public sector authority. The requirements of the contract are communicated by the holding company to the company providing the facility and the operating service company through the secondary contract, and then passed to the subcontractor through the subcontract. SPV financing will be used for the construction of public facilities and for maintenance and asset resets during the contract period.(Henjewe 2014)

Prior to the financial crisis in 2008, large PFI projects could be funded through the sale of bonds or senior debt, and after the financial crisis occurred, more through senior debt financing. While smaller-sized PFI projects, which account for the majority in quantity, have long been funded directly by banks in the form of senior debt. The financing cost of senior debt is generally higher than that of bonds. PFI projects generally require re-raising of funds, and re-raised funds can be financed through bonds. Once the project is completed, the project's risk level is reduced, resulting in lower cost financing(Geoff 2013).

PFI is based on two major theoretical principles: risk management and value for money (VFM). When related to risk management theory, the main role of PFI is to allocate risks in a more reasonable way. For instance, the contractors obtain project fixed charges to reduce commercial risks by actively undertaking project construction and operational risks. The VFM principle is a comparative model that uses a full-life-cycle cost analysis comparison to find out the more economical and efficient one between PFI mode and traditional procurement mode.(Robinson 2010)

4.Advantages and Disadvantages of PFI

4.1 Advantages

4.1.1 Reduce financial burden

Instead of relying on debt financing, the construction of PFI projects is dominated by private investors who bear the risks of construction and operation. In the PFI project, the role of the government changes to a purchaser from the traditional project provider. Taking the current situation in the UK market as an example, the cost of issuing government (or local government) long-term debt is about 2% to 4%. The PFI project that has been put into operation has a yield of at least 6%, which reduces burden on government's financing.(Tan 2018)

4.1.2 Improve efficiency

It is widely believed that the private sectors have better performance in managing investment projects and achieving overall cost efficiency. Additionally, the SPV is responsible for operating the asset which means it has motives to reduce long-term running costs at the outset.(Tan 2018)

4.1.3 Higher quality assets

The implementation of the PFI project requires bidding process, which means more competitive company is chosen to complete the project. Therefore, they can provide dynamic creativity and are obliged to maintain the assets during the contract period, which can bring benefits to the users of these assets.(Acca 2016)

4.2 Disadvantages

4.2.1 Employee benefits decline

Some PFI contracts require the private sector to still employ the original employees of the public sector, and their employment contracts are transferred to the private sector through the TUPE transfer process, which often means a decline in employee benefits.(Hellowell 2009)

4.2.2 Potential risk

Although part of the risk in the public sector is transferred to the private sector, the ultimate risk of the project lies in the public sector. Private financing agreements are complex to organize and do not guarantee a better cost-benefit analysis of public sector projects by the private sector. And some studies have pointed out that the calculation of PFI project risk is very subjective and tends to be biased towards the private sector(Tan 2018).

4.2.3 Value for money

Jean Shaoul, a professor at Manchester Business School, studied 12 large PFI hospital projects and found private companies to have a yield of 58%. Some PFI projects earn excessive profits by refinancing funds, while taxpayers do not have the right to share the benefits. Many PFI project expenditures have significantly exceeded expectations. (Jean 2011)

4.2.4 Debt costs

Private purchases result in additional costs compared to public procurement. The 2010 National Infrastructure Program estimates that the indicative capital cost of PFI is 2% to 3.75% higher than the cost of government gilt bonds(Henjeweile 2014).

4.2.5 Higher expenditure

PFI's procurement process is slow and costly, such as the high expenditures of consultants and lawyers and the cost of the tendering process, which directly leads to increased project costs and reduced project value.

5. Critical evaluations on PFI schemes

5.1 NHS

In the mode of PFI, the NHS Fund Trust has a long-term cooperation agreement with the private sector, which is responsible for the design, construction, renewal, maintenance and provision of complementary services for hospital projects, but usually does not involve the hospital's core medical services. This act of private financing not only saved bad-managed hospitals from bankruptcy, but also reduces a large-scale expenditure of NHS. As of the end of March 2016, there were 716 PFI/PF2 projects in the UK's infrastructure and public services sector, of which 686 were in operation with a total value of £59.1 billion.

However, despite the fact that the PFI project is widely used in the UK national health service, some scholars believe that PFI increases the repayment burden of NHS trusts, mainly due to the increase in financing costs. (Su 2018) A report on 125 PFI hospital projects showed that NHS and local governments spent nearly £10.7 billion on PFI projects in 2010–2015. NHS will continue to pay private companies based on the project contract cycle £80.8 million in fees, which means that 8% of NHS funds were paid to private companies in the form of pre-tax profits over the past six years, during which time NHS hospitals had accumulated liabilities of £3.4 billion. (Zhou 2018) At the same time, the analysis of 128 PFI hospital projects found that 8 private companies own 115 PFI hospitals, meaning that 90% of PFI hospitals are in the hands of 8 private companies. This indicates that private companies may monopolise the NHS projects and are likely to affect the quality of medical services. For example, reducing the number of service beds and employees to control cost expenditures or receive a large number of self-paying patients, and increase private income by providing private medical services to crowd out NHS public resources. (Su 2018)

Confronted with the growing demand pressure and the tightening of government investment, whether the NHS continues to use the PFI project is widely argued.

5.2 Carillion

On January 15, 2018, the Carillion Group declared bankruptcy. In the PFI market, Carillion is an important player: public sector contracts account for 45% of its UK revenue and hold about 420 contracts with the UK public sector. It was once one of the UK's largest construction companies - with around 43,000 employees worldwide, known for working with the Royal Opera House and the famous Donut Building at the UK Government Communications Headquarters. The company also provides a number of outsourcing services

to the public sector, including school dinners, maintenance and operation of buildings and manors, security and housekeeping, and cleaning and catering services at NHS hospitals.(CIOB 2018)

When Carillion went bankrupt, it signed nearly 500 contracts with the HM government – including building hospitals, roads and other critical infrastructure. The company provided a staggering \$1.2 billion to subcontractors (many of which are small and medium-sized family businesses) for £1.2 billion, and these companies are unlikely to get paid. Carillion also left a record £800 million pension deficit, the biggest gap absorbed by the Pension Fund (PPF) in history. Of its 2017 profit loss, £375 million was attributed to cost overruns for three public-private partnership (PPP) projects: building a new £335 million Royal Liverpool University, a £350 million new Midland University Metropolitan Hospital, and a road project in Aberdeen, these projects are plagued by delays and rising costs (Goodley 2018). What is worse, the external auditor (KPMG) did not qualify Carillion's audit report, and its internal auditors did not raise significant concerns about corporate governance, risk management and internal controls.(RADIX 2018)

The collapse of Carillion suggests that the risks faced by debt financiers, governments and public service consumers should not be neglected, and when the PFI transaction collapses, the risk will return to the public sector. The collapse also points to systemic flaws that governments, regulators, and the accounting profession need to recognize and resolve.

6.External Audit

The National audit office (NAO) evaluated five PFI projects and concluded that a number of lessons learned from adopting PFI could be used to improve other forms of procurement and help the government achieve its goals. At the same time, the government should make more efforts to become a smart customer in project procurement and management(NAO 2018).

Besides, in order to ensure the best value for money for all types of procurement, the public sector needs to develop the “successful promoters” that NAO has identified, which includes collecting better data, providing information for decision making; ensuring that the project has the right skills; establishing effective arrangements to test, challenge, and stop the project when necessary; and using business sense to get better deals.(NAO 2018)

7. Conclusions

Through the analysis of advantages and disadvantages of PFI and the empirical analysis of NHS and Carillion, it can be seen that although PFI is a way of public sector financing and sharing risks, and can improve operational efficiency, there is an increase in debt costs and risk of private companies monopolizing the public projects. On the other hand, for the private sector, blindly accepting the PFI project may also bring high risks if the project cost is not properly assessed. For the defects in the PFI model and the lessons learned from the failed PFI project, all government departments should improve the corresponding implementation measures to maximize the value of the government's funds.

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