

Critical Evaluation and Appraisal of the "P.F.I." and value for money



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1. EXECUTIVE SUMMARY

The article can be divided into four parts. The second part provides an introduction of mechanism of Private Finance Initiative (PFI), in which the private sector is responsible for investing private capital and providing the public services together with governmental department, which often lasts for 25-30 years. The mechanism of PFI is followed by the organisational structure of it, including the awarding authority, the special purpose vehicle and third party funders. The third section of the introduction part demonstrates the importance of PFI.

The third part of this article is the main body. In this part, the advantages and disadvantages of PFI are clarified, and two examples happened in the UK and Japan separately, from both positive and negative aspects, are illustrated to connect theoretical knowledge with practice. Then the impact of Brexit and VfM on PFI is simply demonstrated. The Brexit will pose a negative impact on the construction of infrastructure and the provision of public service. The VfM is decisive to the implement of PFI projects.

In the fourth part of the article, the audit agency is explained, as well as its significance for PFI. Then the article illustrate the developing trend of PFI that its improved version PF2 has been created and put into use.

1. INTRODUCTION

1.1 MECHANISM OF PFI

Private Finance Initiative (PFI) is a specific type of Public Private Partnership (PPP). Zarco-Jasso (2005) defines PPP as a “ cooperative agreement where public sector agencies enter into long-term contractual relationships with private sector entities for the construction or management of public sector infrastructure ” . In a PFI program, a contractual agreement is established between the public sector and a consortium of private sector firms, which is known as the Project Company, that defines the private sector as the subject who takes the responsibility of designing, building, financing and operating an infrastructure facility (Demirag, I. & Khadaroo, I. 2011; Badi, S.M. & Pryke, S.D. 2015).

According to the development plan and social needs, the government determines the preliminary plans to meet the needs, evaluates the cost and expected benefit of operation to determine whether the PFI mode can be applied to the project, and then propose the program through bidding. The Project Company who win the bidding is responsible for investing private capital and providing the public services together with governmental department, which often lasts for 25-30 years (HM Treasury, 2003).The Project Company shares the risk of construction and operation of the project together with the government , and makes profit through the government procurement and tolls from the service receivers, then return the project to government at the end of the concession period.

1.2 ORGANISATIONAL STRUCTURE OF PFI

There are typically three parties constituting PFI constructing project, they are (1) the awarding authority;(2) the special purpose vehicle (SPV); and(3) third party funders.

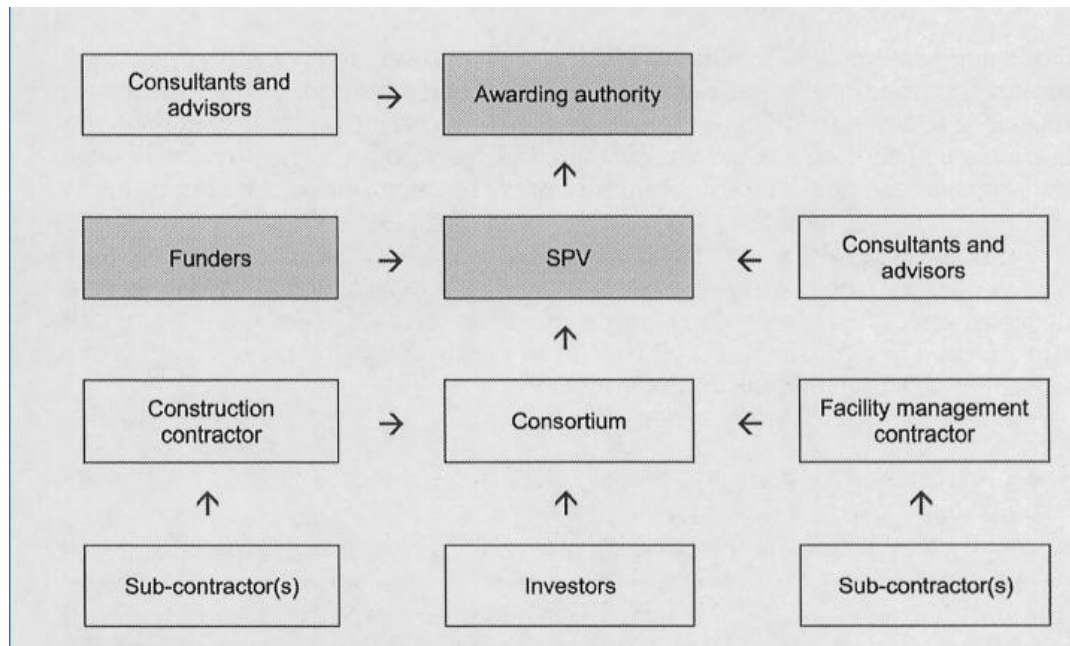


Fig. 1 PFI project structure. Source: Adapted from Dixon et al.(2003b)

The awarding authority may be a governmental department, a local authority of the central government or a government representative, it is responsible for the implementation of government procurement. The aim of awarding authority is to transfer the risk in relation with providing infrastructure and services to private sector, thus realizing the value of public money (Fox and Tott, 1999). The SPV is a limited company whose unique objective is to deliver the project with reducing the risk to minimum (Dixon, T et al, 2005). The minimum risk is achieved by distributing risk to sub-contractors. Public projects usually need a huge amount of capital input, and it is not enough to rely on the capital of private investors, so the financial support from third parties such as shareholders and bank loans. The aim of the third party funders is to make profit through investment in the project(Fox and Tott, 1999).

1.3 IMPORTANCE OF PFI

PFI is actually deemed as a critical government procurement tool, which lays more emphasis on the initiation of private funds and the active involvement of domestic private enterprises , aiming at the realization of diversified channels of public project financing construction and operation(Yu Yajuan and Ye Xiaosheng, 2010).

In the UK, it used to be the government's responsibility to provide public infrastructure and services. However, it was widely acknowledged that the public

services and infrastructure projects were poorly managed by public sectors, which conducted overspend on time and money, as well as long-term technical problems (Mott MacDonald, 2002). For example, the survey of Graves and Rowe (1999) about public sector procurement indicated that the completion of two thirds of programs had been delayed and the budget of 75 percent of projects had been exceeded. Consequently, increasing attention was paid to PFI by the British Government since 1992, after the proposal of which, there has been a dramatic shift in successive governments' approach to public sector procurement (Fox and Tott, 1999). Since then PFI has played a predominant role in the education, health, transport, roads and prison services sectors of the economy (HM Treasury 2009), acting as a method to apply severer control on public expenditure to curb inflation (Kee and Forrer, 2008).

2. MAIN BODY

2.1 ADVANTAGES & DISADVANTAGES OF PFI

2.1.1 Advantages

Multiple studies have underlined the importance of PFI. The main advantages consist of the following points.

Firstly, PFI is beneficial to alleviate the fiscal burden of the government. In PFI project, the government signs long-term contracts with the SPV through government procurement, in which the private sector bears the full cost of capital for the project and the government does not need to rely on debt issuance to finance infrastructure projects, thus releasing the heavy burden of government's national debt.

Secondly, PFI is conducive to promoting the diversification of investment subjects. The government usually enters into a payment commitment with the financial institution that provides the loan to the SPV. This agreement enables the company to get the loan from the financial institution smoothly (Yu Yajuan and Ye Xiaosheng, 2010). Creditors are more willing to lend, and the project leverage ratio is generally very high, usually ranging from 80% to 90% (Shu Li, 2015).

Thirdly, PFI provides a rational allocation of risk between the government and the private sector. The risk is transferred to those who are more capable of managing them.

Futhermore, PFI will encourage timely and cheaper delivery. Since the private sector will not be paid until the project is completed, PFI will definitely contribute to lower cost and better efficiency.

2.1.2 Disadvantages

Notwithstanding the advantages of PFI, it cannot be denied that there are also some disadvantages of PFI.

Firstly, the overall cost of PFI may be higher. In PFI project, the role of the government changes from project provider to purchaser. Although the government does not bear construction and operational risk, it will bear higher financing cost correspondingly. Also, owing to the long-term progress of program, the total liabilities and returns are not transparent, and the procurement investment phase is too complex, government tend to attract the involvement of private sector by high payment.

Secondly, the contract of PFI is inflexible. Since the project often last for 20-35years, taking the continuously changeable environment into consideration, the long period of contract results in increasing commercial risk and the high

monetary values. Also, the control ability of public facilities declines, and flexible adjustment cannot be made to adapt to the change of public demand, which leads to damage to public interests.

Thirdly, the ultimate risk still lies with government since it actually has to pay for the risk transfer (Audit Office, 2011).

2.2 IMPLEMENTATION OF PFI

2.2.1 Skye Bridge in the UK

Isle of Skye is a famous tourist resort in the northwest of Scotland. Skye Bridge is highway bridge across Alsh lake, which is a critical transportation infrastructure which connects Isle of Skye and Scottish land. The bridge, a single-span concrete arch bridge with a main span of 400 metres, is considered a successful PFI project by the National Audit Office (NAO). The awarding authority is development department of Scottish government, the SPV is Skye Bridge Ltd., who is responsible for investment management and charging for the bridge. The whole project had been planned since 1986, started construction on June 29th, 1992 and opened to traffic on October 16, 1995.

In the contract, Skye Bridge Ltd. ought to finance the project, which produces the acquisition of assets and future income, but the assets of the Bridge belong to the government during the concession period. In addition, Skye Bridge Ltd. must complete the design and construction of Skye Bridge in accordance with the technical requirements of the Scottish development department. Besides the realisation of basic rules, including VfM and risk allocation, the greatest success of the project was in its early planning and procurement, which led to its completion at lowest cost (Wang Qiang, 2016).

3.2.2 Kochi county central hospital in Japan

Since 2000, old Kochi county central hospital together with the old Kochi city hospital in Kochi, Japan, who provided medical services for the county was facing serious problem of aging medical facilities, narrow service space and operating loss, leading to their upcoming collapse. Therefore, the local public organizations decided to merge the two hospitals, hoping to build a large comprehensive medical center that can provide efficient, convenient and advanced medical services for the whole county. And they decided to use PFI model. ORIX company won the bidding, and they have taken BTO and BOT methods, signing a

contract of 30 years. The new hospital started operation in March 2005, and became quite successful in merely one year, which was expected to be achieved in four to five years. However, the financial statement from 2006 to 2008 showed that its annual net liabilities exceeded the estimated ones of more than 400 million yen.

To improve the situation, a hospital personnel committee was composed for advancing the management Kochi medical center, although the committee received great support, SPC and the hospital also made great efforts for this purpose, losses arising from the operation still cannot be made up for. Therefore, SPC finally applied for the termination of the PFI contract, and reached an agreement with the hospital in March 2010 to officially terminate the project.

When it comes to the reason for failure of this program, there are many different aspects, such as labor, material expenses, they are all far from the expected level. Severe problems also existed in the management of SPC. Furthermore, the calculation of VfM proved to be incorrect. The case proved that the PFI does not always succeed that it needs to be chosen and considered carefully.

2.3 IMPACT OF BREXIT TO PFI

At present, the UK is the joint major shareholder of European investment Banks. However, after Brexit, the future loan decisions of European investment Banks with the UK will inevitable decrease. Given the possible macroeconomic impact on the UK government's finances of Brexit, it is reasonable to conclude that some significant PPP programmes are likely to face further delays (Robin et al, 2016).

Also, the uncertainty caused by Brexit may lead to the situation that some PFI projects take more time to finished than expectation (both in terms of documentation and construction), and the likely currency fluctuation owing to Brexit may result in more cost (Clifford Change, 2016).

2.4 VFM OF PFI

The UK is the earliest country who introduced the VfM assessment in the PFI model, which is mainly used for scheme comparison and selection in the practice of the PFI. By using VfM, On the basis of the empirical data of previous similar projects, the potential benefits of different modes providing this public service are compared, and the selected schemes are evaluated and compared, so as to

select the scheme that can provide the maximum VfM (Shen Yuyu, Du Jing, 2008).

PFI was deemed as an affective and efficient means to fund public infrastructure by encouraging the private sector to invest in infrastructure projects. A further motivation was the belief in the capacity of the private sector to achieve improved Value for Money (VfM) and deliver greater efficiency (HM Treasury, 2003).

Through the calculation of VfM, the feasibility of adopting PFI mode for the project can be better qualitatively evaluated, which can provide sufficient and accurate basis for the decision-making of the government public sector and increase the success probability of the project's efficient construction and operation.

3. CONCLUSION

3.1 THE AUDIT AGENCIES

The National Audit Office (NAO) helps Parliament hold government to account and improve public services (NAO, 2019). The organisation audits the financial statement of all public sectors, and carries out VfM studies, local audit, investigations and other significant activities. Also, it will provide useful recommendations and reports for government to optimize the quality of public services. VfM has played a crucial role in the implement of a PFI project, and the responsibility of audit agencies comprises VfM study, consequently, the importance of audit agencies cannot be emphasized too much.

3.2 DEVELOPING TREND OF PFI

It is widely accepted that PFI has benefited the construction of infrastructure and provision of public services greatly, however, there still exists many disadvantages and doubts that cannot be overlooked. In order to produce better cooperation between public and private sector, some improvement has been made to PPP, one of which is the creation of PF2, the improved version of PFI. Despite of it, continuous studies about PFI and PF2 is needed to find out a better methods which can contribute to the construction of infrastructure and the provision of public services more.

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