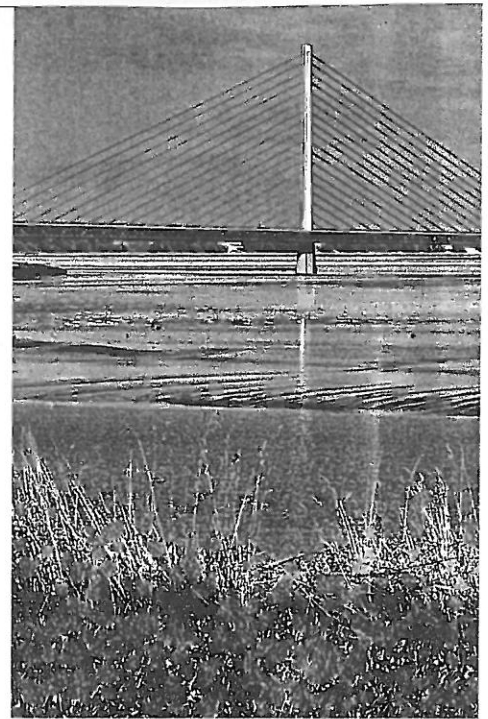


Analysis

Private finance

Son of PFI: achievable or a bridge too far?

Dubbed the 'discredited' way to deliver public infrastructure by Chancellor George Osborne, the Private Finance Initiative has fallen far from favour. But with £200bn of infrastructure funding needed, what's the alternative? Richard Johnstone reports



The Private Finance Initiative, hailed by the previous Labour government as a revolutionary way of financing hospitals, schools and roads that may otherwise never have been built, has more recently received a barrage of negative press.

The costs of financing projects soared by 20% after the credit crisis and, while in opposition, Chancellor George Osborne branded it the 'discredited' way to deliver public infrastructure.

The National Audit Office has never been able to prove whether it is better or worse value for money than other forms of procurement. Its most recent report, *Lessons from PFI and other projects*, warned that the private sector's commercial skills were much greater than the government's, and that the use of PFI was not challenged enough.

The hunt is now on for reforms – and alternatives – to the model, as even the most sceptical can't see a way ahead without some form of private finance.

Osborne abolished Treasury-backed PFI credits in last year's Comprehensive Spending Review, meaning that, aside from a tail end of schemes taken forward

under the old system, departments must now support any such initiatives through their own budgets. This – coupled with changes that supposedly put projects on the national balance sheet – was seen as the beginning of the end for PFI.

However, the government admits that about £200bn will need to be spent over the next five years on energy, transport, digital communications, flood protection, water and waste management. According to the NAO, the majority of this will need to come from the private sector.

Even Jesse Norman, the Conservative MP leading the Campaign for a PFI Rebate, set up to try to claw back from the private sector some of the money spent on 'shockingly expensive contracts', concurs. He told *Public Finance*: 'I do not think that it's likely that the £200bn that they're estimating will be delivered without some kind of private-sector capital.'

Sixty-one PFI projects are being procured by the government, which, Norman says, represents it 'wrestling with the sausage machine it inherited'.

One PFI lawyer, Stephen Matthew, a partner at Nabarro, says that following

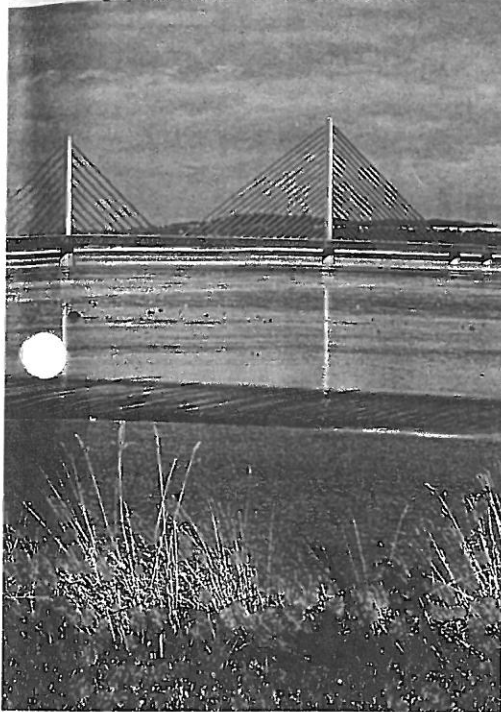
the government's changes to PFI, the market is finding new ways to finance schemes. 'We're looking at a "no grant" and "no PFI credit" world, but there will still be capital programmes.'

One project being developed under a new funding model is the £430m Mersey Gateway bridge. Finance for the scheme, which is being undertaken by Halton Borough Council, is expected to be agreed by mid-July.

The bridge had been due to receive £123m of PFI credits, but project director Steve Nicholson tells *PF* that it is now likely that the scheme will be given direct capital funding from the Department for Transport. This is expected to cover 30% of the project's costs, thereby decreasing the amount that has to be borrowed and reducing the impact of rising borrowing costs. The loan on the remaining 70% will be repaid with money raised from charging tolls on the bridge. This funding cushion from the DfT will help deliver 'best value for money out of the toll revenue stream', Nicholson says.

He adds that funding is expected to be announced when the Treasury

Direct route: Having lost its PFI funding credits, 30% of the cost of the Mersey Gateway bridge scheme is now likely to be covered by direct funding from the DfT



20% THE INCREASE IN THE COST OF FINANCING PFI PROJECTS SINCE THE CREDIT CRISIS

Quote unquote



'These projects will often still be off balance sheet... It may still be attractive for government departments to use the PFI'

David Findlay, director of corporate finance and infrastructure team, National Audit Office

'The PFI is insensitive to the different types of public infrastructure being created. It may well be that the next generation will not be one-size-fits-all'

Jesse Norman MP, Campaign for a PFI Rebate



is 'comfortable' with the capital contribution to be provided by the DfT. Such direct financing from Whitehall is a model currently 'frowned upon' by the Treasury, Nabarro's Matthew observes. But the high costs of borrowing mean the government may have to rethink its approach – and the case of the Mersey Gateway bridge could help it to do so, he says.

'The view on this is, will it reduce the overall project cost by reducing the cost of borrowing? Or, to put it the other way round – will the banks only lend if there's a contribution that means they won't take all the risks?'

Matthew says PFI-style financing is most likely to survive in schemes like this. They allow local authorities to raise their own revenue stream to pay off the debt incurred without long-term central government support, while also allowing them to transfer the risk of the project and increase the price certainty.

David Findlay, director of the corporate finance and infrastructure team at the NAO, argues that a difference in accounting rules may also make PFI attractive in years to come.

He says that individual projects are now required to be on the balance sheet of the government department or local authority responsible for them, but they still sit outside the separate calculation of the national debt. 'The consequence of that is that it may still be attractive for government departments to use PFI to get that treatment.'

Norman hopes that the Treasury select committee, which is set to start taking evidence on the future of the Private Finance Initiative, will examine what 'a son of PFI might look like'.

Other sources say that PFI is likely to be one of a number of models where the finance agreement is fitted to the project, and Norman agrees.

He says that PFI has been more successful in delivering infrastructure like roads than hospitals. 'One of the problems with PFI is that it's insensitive to the different types of public infrastructure being created. It may well be that the next generation will not be one-size-fits-all – maybe transport infrastructure has a certain type of approach, for example. Certainly, there needs to be a recalibration.'

At the local level, an investigation has started into new funding mechanisms. The New Local Government Network launched its Capital Futures project in May. This is examining ways in which 'councils can raise investment finance from non-governmental sources, exploring in particular detail the various options for using municipal bonds to finance development'.

The project began following the demise of PFI credits and the increase in the borrowing rate of loans from the Public Works Loan Board, which amounted to an effective 25% rate hike. A report will be published in late 2011, but a preview paper seen by *PF* states: 'The largest of local authorities may find most benefit in independent bond issues. For smaller authorities, the scale of their capital investment would preclude this and they would therefore be more suited to a [joint] club arrangement.'

Whatever its final recommendations, Matthew, whose firm is involved in the NLGN's research, sums up the dilemma: despite PFI's unpopularity, 'there will be capital schemes, in health for example, [and] the government will still look to project finance solutions like PFI to deliver infrastructure'.

'If you read some of the press, you'll conclude that PFI might need a different name, but I think that kind of approach – where the private sector builds and finances infrastructure – will still be needed.' 