

Public sector accounting

Extending the Private Finance Initiative

**What is the PFI?
Asks Michael Mumford**



Michael Mumford

From 1979, successive Conservative governments in Britain introduced privatisation, compulsory competitive tendering for local authorities, executive agencies to run many day-to-day government functions, and finally in 1992 the Private Finance Initiative (the PFI). Under the PFI, public agencies, rather than buying major new assets, seek private suppliers to finance the purchases, own the assets and supply their services under long term contract.

Between November 1994 and May 1997, the Treasury required every public project proposal to be "tested" to see whether a PFI contract could be adopted instead. The new Labour administration endorsed the PFI in 1997, while ending compulsory testing.

While governments claim that the PFI shifts risk from public to private sectors, there has been little explanation of why this should benefit taxpayers or the economy. After all, private firms pay more for their capital than government does, and they need to charge for taking commercial risks and investing funds. Moreover, negotiating PFI contracts is costly. Finally, critics claim that the PFI is merely a way to reduce the Public Sector Borrowing Requirement—mere "off balance sheet financing". However, there are good economic reasons for the PFI,

where circumstances are suitable (discussed below).

Seven billion pounds worth of PFI contracts have been signed to date, although half this figure relates to the notorious Channel Tunnel link. AMEC is upgrading and maintaining a 55 kilometre M4/M5 link road in Gloucestershire; John Laing is negotiating the £250 million Norfolk and Norwich hospital; London Underground has retained GEC Alsthom to provide a fleet of new trains for the Northern Line; the Ministry of Defence is contracting for new facilities in Shropshire to train helicopter pilots; and Siemens is supplying a computerised database for the Home Office Immigration and Nationality Department. On a similar scale, Jarvis has agreed with Dorset County Council to build and maintain new premises for the Colfox School. In each case, positive discounted net present value is expected, even at commercial costs of capital.

Why should the PFI offer benefits?

PFI projects make economic sense in the same circumstances as private sector outsourcing agreements. "Downsizing" helps companies to save costs by forming supply chains with specialist external suppliers of inputs.

Traditional economic analysis

cannot explain why changing the "organisational architecture" in this way adds value, but a newer branch of economics, Transaction Cost Economics (TCE), emphasises the need to save costs that arise when transacting parties have "asymmetric information"

(unequal knowledge), particularly in deals for major fixed assets suited to only a limited range of purposes. TCE also warns of "opportunism"—the risk that people will act dishonestly, using guile.

The main aim of TCE is to explain when firms are better off carrying out production themselves (as "core" activities), and when they are better off buying inputs instead, either day-today from well traded markets or under long term contracts. PFI contracts operate over many years; they exclude finance leases (under PFI rules), but consist of comprehensive service agreements with detailed specifications.

PFI service suppliers need: (a) scope to exercise their specialist skill and effort in designing and constructing facilities; and (b) continuing incentives to maintain supplies over the contract duration.

Under conventional asset purchases, public agencies forecast the services they need to provide in future years and the resources required to meet those needs; then they define the necessary capital projects, specifying facilities and placing orders to have them built by private constructors (whose responsibility largely ends once the assets are in commission).

Under the PFI, by contrast, the constructor has prime responsibility for designing and building the assets (to meet client's service requirements) and continues to own and operate them over their economic life. Projects are designed to control and reduce lifetime costs, which suppliers have to bear.

It takes different skills to construct buildings than it does to maintain reliable services, so suppliers usually form consortia of specialist firms, collaborating together to ensure that contract services are delivered on

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schedule. Purchasers do not begin to make any payments until these services commence, so suppliers have an incentive to avoid delays.

In my study of the PFI, I identified six sources of cost saving that these contracts may be able to offer, compared with conventional projects:

- (a) Clearer definition and specification of user needs (since public agencies are forced to think hard about what they need before committing themselves for thirty years);
- (b) More careful lifetime design and costing by the constructor (who must live with the consequences, rather than transferring ownership to the client);
- (c) Speedier construction and commissioning (since service payments only begin after completion, and penalties may also be imposed);
- (d) More effective monitoring of contracts (since supply consortia have incentives to monitor delivery systems, while clients only have the easier task of checking service quality and scheduling);
- (e) Incentives that better align effort with risks and rewards (well-focused goals on the part of suppliers can be translated into incentive schemes); and
- (f) Decision-making that better exploits asset compatibility (parties own only those assets that they need to own for operational efficiency, and responsibility can be better matched with authority).

A way to improve the PFI

Where the PFI is weak at present is in its excessive bureaucracy. Current contracts include as much detail as possible, in order to identify, allocate and price every responsibility. This is

feasible in the case of contracts for services that are unlikely to change over several decades, like motorway provision; here it is improbable that technical change will make the facilities obsolete within the contract period, and patterns of service requirements are predictable. But where services are likely to become out of date, it makes no

sense to form comprehensive ("complete") contracts, which are very costly to negotiate and to renegotiate when conditions change.

Nearly everyone I interviewed while writing the book (see below) agreed on the need for less formal, "relational" or "incomplete" agreements, more like partnerships than contracts enforceable by the courts. As explained in the book, incomplete contracts are not fully spelled out in advance. They depend on reliable mechanisms for frequent discussion and renegotiation, informally more often than formally. Parties must maintain a balance of powers, so that each sees future collaboration as producing benefits that outweigh the costs. This means balancing commitments amongst parties as well as benefits from future dealings. The government's main role in this would be to provide fair and impartial arbitration.

At present the PFI is damaged by private sector suspicions that the government can always change the rules to suit public interests, while public purchasers view private bidders as unimaginative and profoundly risk-averse. Better partnership relations need genuine power sharing, not more regulation. Adopting relational contracts may make it more difficult to raise externally, but it would suit smaller projects such as schools and social housing schemes, and it would expand the scope of the PFI.

Michael J. Mumford of the International Centre for Research in Accounting, Lancaster University, was an ACCA Council Member for 15 years until 1997. His book, *Public Works—Private Finance: the Principles of the Private Finance Initiative*, is to be published by Richard Griffin (1820) Ltd. in March 1998 at £40.