

DBULLETIN

What Next for PFI?

In the first of two articles concerning the role of PFI under a possible Conservative government, Rebecca Pearey explains why she considers PFI definitely has a future.

The Private Finance Initiative ('PFI') was first introduced in the early 1990s by Conservative Chancellor, Norman Lamont. However, it was not until Labour came into power in 1997 that PFI started to be used more widely as a mechanism for delivering projects through local authorities. The Labour Government has since signed more than 640 PFI contracts, despite PFI coming under ongoing scrutiny over procurement costs, balance sheet treatment and risk transfer.

All of these are issues that could potentially resonate with the public in the current economic and political climate. Not surprisingly, with the next general election fast approaching and a universal recognition that the public sector balance sheet is unable to take much more stress, there have been murmurings from within the Conservative party suggesting that the days of PFI may be numbered.

Perhaps the strongest statement to date has come from George Osborne, the shadow chancellor. He commented in November 2009 that "Labour's PFI model is flawed and must be replaced. We need a new system that doesn't pretend that risks have been transferred to the private sector when they can't be, and which

genuinely transfers risks when they can be."

We also understand that the Conservatives have instructed Philip Hammond, shadow chief secretary to the Treasury, to investigate alternative funding models for major projects that deliver better value for taxpayers. There have been calls from within the party for more transparent accounting in order to remove the "perverse incentives that result in PFI simply being used to keep liabilities off the balance sheet". (A viewpoint incidentally that chief secretary to the Treasury, Liam Byrne, perhaps does not share, instead commenting that ending PFI could transfer more risk to the public sector).

So, on this evidence, would the election of a Conservative government spell the end of PFI? Whilst there is perhaps nothing more risky than making pre-election predictions, our instinct is to say "no", we think not.

Our view is that the ire of the Conservatives is directed less at PFI itself, and more at "Labour PFI" (note the quote from George Osborne above) and certain of its perceived characteristics. For example, last year, the Conservatives published a policy briefing, *Reconstruction: Plan for a strong economy* which set out 5 key principles to be complied

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with for all PFI contracts under a Conservative government. The 5 key principles are as follows:

1. Proper Accounting. All public sector contractual payments to private promoters will be taken into account when assessing the sustainability of the public finances.
2. Proper incentives for the private sector. All state contracts with private promoters will include a few simple and clear outcomes, and the private promoters will pay liquidated damages if those outcomes are not delivered.
3. Where a Government subsidy is justified in order to make a project economically viable, it should be made transparent. If the wider social and economic benefits of the project justify the subsidy, then the subsidy should be made explicit by financing it through government spending.
4. Private sector must bear the risk. The Conservatives will engage private providers if they can effectively transfer all those risks which are reasonably within the control of the providers. If no private provider is willing to bear the vast bulk of the risk, then the project should either be abandoned or take place in the public sector.
5. No micromanagement. All contracts will be negotiated so as to allow the government to terminate the contract and seek liquidated damages in the event that the private promoter fails to deliver.

Our belief is that a Conservative government would be focusing on addressing these issues,

rather than a wholesale abandonment of PFI. Lest we not forget, PFI has been, in pure delivery terms, a very successful and well established method of procuring public sector assets through the use of private sector capital. So successful in fact that it is being replicated throughout Europe, the Americas, Australia and Asia. Whilst few would deny that it could benefit from a review and some fine-tuning, would any new government really dispense with such a tried and tested mechanism of leveraging private sector finance into the economy? Particularly at a time when not only is public sector capital in such short supply but also there is no viable alternative to replace it.

Indeed, recent Conservative statements on the future of PFI were they to come to power have perhaps become a little less bullish. Their criticism of PFI has become narrower and has tended to focus on specific public service areas. It is Education (Building Schools for the Future), Health and Waste that have been the sectors that have borne the brunt of the Conservatives' most recent call for change, whilst housing has stayed out of the firing line despite the £1.8bn investment set aside for the forthcoming round 6 Housing PFI Projects.

We believe the reason for this is that Housing involves the use of assets and the provision of services that are far better suited to long term contractual arrangements such as PFI: with the greatest respect to our construction and housing colleagues, there is only so much change that can be brought to a dwelling and the services to that dwelling.

Also, the "private sector" has been delivering

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affordable housing for 30 years or so and well established methods of service delivery by a large pool of regulated and effective providers already exists.

This contrasts with sectors such as education, waste management and health. These are areas where substantial change is inevitable over a thirty year period, whether driven by the dynamic and complex nature of the service relationships and aspirations or simply by technology. For example, the approach to delivering health services is forever changing. Whereas not so long ago, large, institutional multi disciplinary acute hospitals were seen as the blueprint for healthcare, we now have far more sophisticated local (and in some cases mobile) facilities from which specialist services and procedures that were formally the preserve of those large acute hospitals, are being delivered.

Waste management is another area that has been transformed and will continue to be transformed. The drivers here are perhaps different. Climate change, the need to make better use of our limited resources and a better understanding of the implications of landfill, incineration and recycling have all led to an ever changing regulatory environment which is set to continue as we continue to strive for the

optimum way in which to process and dispose of our waste. With technology also advancing quickly to respond to all of these challenges and opportunities, a conventional PFI contract has to incorporate very considerable (and non punitive) flexibilities to be able to serve the sector well over a 30 year period.

Education partnerships require similar levels of flexibility.

So, based upon this analysis, PFI within a housing context looks very different and, in our opinion, a far better, long term fit for the current PFI model than is the case with certain other sectors. That said, we still do not believe that PFI will disappear from these other sectors. It will undoubtedly change and may even be re-badged under a Conservative government but, at the moment there is no evidence of any readily available alternatives. PFI has been delivering projects across a wide range of public services for over 10 years and, during that time it has remained under a very bright and critical spotlight. It may be over simplistic for a new government to wave a magic wand and produce a viable alternative.

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