Public services, private finance: good or bad? Transcript

Date: Thursday, 3 March 2005 - 12:00AM

PUBLIC SERVICES, PRIVATE FINANCE: GOOD OR BAD?

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1. Introduction – what are the issues?

A little tell tale sign about what PFI, the Private Finance Initiative is really being used for, is that when the Conservatives were in government and introduced the first PFI, in April 1987, to finance the Queen Elisabeth II Bridge near Dartford, the Labour Party was a fervent critic. Today, the Labour government is a champion of the PFI, although they call it PPP, public-private partnership – a nice sounding collection of opposites. The Conservatives are now critics, and refer to the blossoming of their bulb as the *black hole* in the government's finances.

PFI is a device for government to keep oppositions out. It works by allowing the government to spend more, on politically sensitive issues like hospitals, schools and affordable housing, in politically sensitive places, without startling the electorate with higher taxes or new debt. *Any opposition would consider such an invention a curse*.

It is somewhat ironic that the Grantham Grocer should build a political reputation on a homely economics, where there are no free lunches, and have as one of her government's lasting legacies, something that looks like, smells like and feels like a free lunch.

From whichever direction they come from, free lunches are attractive for the politically hungry. Despite their early opposition UK government officials could not be more enthusiastic today. Almost one thousand PFI deals have been signed with a capital value of close to £50bn.

But PFI is not just an expensive accounting trick. True believers in PFI do not really make their case around the government's ability to spend without taxing or borrowing. They claim that PFI allows public services to be delivered quicker, cheaper and better. The counter claim is that they are no quicker, no better and only cheaper because they shift employment from reasonably paid public sector jobs to poorly paid private sector jobs.

One of the difficulties in making an impartial assessment of PFI is that so many players are partial. UK lawyers and bankers earn good fees from PFI transactions while unions see their members lose jobs and new non-unionised jobs become vacant. Adding further difficulty is that many of the competing claims have tinges of truth about them.

My assessment is that the Private Finance Initiative can add value, but it can be over-used or misused for political or accounting purposes. In these circumstances the savings it promises are illusory and it can inflict real damage on relationships between staff, management, government and the customers of public service corporations - you and I.

This conclusion applies not just to the UK. The UK government and UK-based law firms, banks and consultants have been aggressive exporters of PFI, with quite mixed results.

At the end of this lecture I propose a new approach to PFI that focuses on PFI's ability to improve the value and quality of public services, but not necessarily reduce their cost. This new approach could offer much better results and opportunities for the Southern hemisphere where public services and resources are more limited as well as for the more extensive welfare states of Northern hemisphere.

2. So, what is PFI?

Permit me a short story. Mr. Beveridge and his son Jarvis go for a stroll in the garden on the outskirts of London. The garden is looking a bit unkempt. Mr. Beveridge turns to his son and says, “Jarvis, here are two choices, pick one. I go and borrow £100 to buy a new lawn mower and then pay you £10 every week to mow the grass. If you don’t turn up or do a good job I get someone else to do it and pay them £10 to use my lawn mower and look after the garden.”

“Or”, Mr. Beveridge continues, “I could write you a note where I promise to pay you £13 per week for a year in return for lawn mower services. These services include you getting a lawn mower to look after the garden to a specified standard for a year and at the end of the year to hand over the lawn mower.”

“You, Jarvis, will take my promissory note to the bank and use it to borrow £100 to buy the mower, you use 2 of the £13 I promise to pay you to pay off the loan and interest and you are left with £11 per week.

OK said Jarvis,

Beveridge continued. “But if you don’t turn up or work well, I will stop your payments and fine you. You will default on the loan and lose the lawn mower and then I will have to take you to court to get compensation, which you won’t have, so you will declare bankruptcy.”

Jarvis looks at his father and says, “Dad are you OK?” Beveridge says, yes of course I am. I have just managed to get your brother to buy all the groceries for a year”. Jarvis turns to his father and says, “Can I be the bank instead?”

Instead of the government borrowing money from the market for 20 years to pay the builder, to build the hospital, the government promises to pay the builder a fee for 20 years for hospital services to cover the building and operation of the hospital.

The builder uses this promise to borrow from the bank and uses the annual fee from the government to pay back the loan and interest, meet the operational expenses and earn a profit margin.

Plain speakers should see something odd about this arrangement. The higher quality borrower, the government, is choosing not to borrow, but instead to pay the borrowing costs of the poor quality borrower and a profit margin. It has swapped a 20 year interest payment for a 20 year commitment to pay someone else’s interest payment. Whether it is called a fee is no matter, there is just a substitution of a high quality borrower who can go direct to the capital markets, for a low quality borrower who goes to the banks.

The UK Treasury steers the accountants to FRS5 rather than FRS21. They don’t see an implicit borrowing for capital expenditure and consumption; they see a current expenditure defined as hospital services. The implicit borrowing is not recorded. The capital expenditure budget is untouched for other purposes.

The politician sees an additional hospital built with no increase in borrowing or taxes. It makes political sense. No surprise therefore than around 1000 PFI deals have been signed with a value of close to £50bn. Close to 100 hospitals have been, are being and will be built using PFI. About a dozen prisons, many schools and social housing. And it is arguable that this capital expenditure would not have happened otherwise. Public infrastructure investment, already given a boost by this government, is close to 15% higher than it would otherwise be. No wonder the opposition is smarting.

3. Off-balance sheet

So why be a party-pooper. Because off-balance sheet borrowing should make you feel uncomfortable, especially when it is Britain Inc and you are a share holder. We are effectively committing our sons and daughters to years of expensive payments without being very transparent about it. There are parallels with this kind of off-balance sheet financing and activities at companies that we would consider were designed to commit a fraud against the shareholders such as Enron, Parmalat and WorldCom.

But to focus exclusively on the off-balance sheet and poor debt planning is to miss the real point of PFI or of public provision and private delivery in general. The real point is about using the market to deliver better value. The real financing costs of PFI are greater than standard government borrowing, but it may be that this cost is worth paying if projects are completed on time, within budgets, if operational costs are lower and standards higher. PFI proponents argue that competition and performance related penalties deliver just that.

So, we should be looking for these benefits explicitly and not trying to exploit an accounting gimmick. PFI deals could be treated as capital expenditure and there should be a place in government accounts for a consolidation of all of the payment commitments of PFI deals the government has struck and the effective rate at which it has borrowed money from future tax payers to pay for services today and tomorrow. Indeed, this would be in the best interests of PFI. If PFI is off-balance sheet and the full effects opaque, one day a new government is going to walk in, appear shocked and horrified that between all these 20 year commitments there is no discretionary money left and renege on these commitments in some way, perhaps by changing the terms of service contracts and payments. If that were to happen, the implicit borrowing costs would rise sharply making all PFI uneconomic and making it a financial dodo; a flightless bird now extinct.

4. Non-financial benefits and costs of PFI

Do these wider benefits of PFI exist? The Guardian newspaper and others revel in the horror stories surrounding PFI. The new schools with leaky roofs and the hospitals with clogged sewage systems and fewer NHS beds than planned but more private ones.

What is often forgotten though is that traditional public sector projects fail quite often too.

Remember Holyrood? The Scottish Parliament was expected to take a couple of years and £43m. Being Scotland, it was a traditional public procurement process, no new fangled PFI, just a tender for a building with some funny windows. It took ten years and £431m, and as the Guardian reported, the roof sprung a leak in its first week.

A National Audit Office Report examined 37 major PFI projects contrasting them favorably with earlier public sector projects. A total of 22% of PFI projects were over budget; but the NAO had found in similar public sector construction project reviews that that 73 percent of budgets were over-budget. There were equally dramatic improvements in delivery time.

Critics of PFI say there is no reason for PFI to be better at delivering capital projects in time. Having contractors pay for the consequences of their delays or poor quality is achievable in traditional contracts. You can redo your kitchen and give the contractor penalties for not completing on time without having to do your own Private Finance Initiative. And where the operator is underperforming government can easily re-compete the operational contract without getting into lengthy legal processes to redress a part owner.

Maybe the reality is in traditional contracts the legal processes are hard to use. Under traditional building contracts when the builder is going to miss a deadline, he saunters up to you, makes a big sucking sound, shakes his head and says he never expected to find foundations that were so deep, or the contingency just wasn't big enough or his right hand man's mothers sister is really ill, and you give in to the delays and the cost over-runs.*How did Holyrood cost so much more?* In a PFI, you make your bed and sleep in it. The builder has already borrowed the money from the bank based on the government's commitment to pay, they can't under-bid in the tender and borrow more from the bank later.

PFIs may be good for the financial brokers, lawyers and consultants but it is not all good for the contractors found wanting.While it is over simplifying It is interesting to note that while the share price of Jarvis with its poor reputation for its PFI projects has fallen by 95% since the beginning of 2002, the share price of Bovis the constructor of Holyrood, has risen by 80% over the same period.

The unions vociferously claim that the way the PFI operators deliver lower construction and operational costs and meet time commitments is at the expense of their members or customer safety. Having bid low for a PFI contract, companies turn a profit by cutting employees wages and benefits. Certainly PFI contractors tend to have non-unionised workers on temporary contracts with fewer employment rights and conditions such as pensions and childcare. The unions claim that PFI is a way for government to get out of its obligations to be a good employer. And they are probably right.

And there are worries on the safety issue. How safe would you feel when you step on to a plane to be told that the license to build and operate the National Air Traffic Controllers has just been won by the lowest bidder, looking to make an attractive return for shareholders.

5. Making PFI right

Concerns about labour conditions and customer safety and quality of product are genuine, but they not intractable. I think the problem with PFI is that there are value for money benefits and short-term political benefits. The short-term benefits relate to cost savings and off-balance sheet financing and the value for money benefits relate to delivery of quality. Not surprisingly, governments have over-invested in the short-term political benefits and underinvested in securing the real service quality benefits.

Through its mistaken accounting treatment, PFI enables the government to spend more and for the future liability to be obscured and through mis-specified tender and auction processes the potential customer benefits are lost.

The auction process itself is a problem for PFI. Auctions are all the rage and this government is a little partial to the fashionable in finance, but price-based auctions are not appropriate for long-term service contracts. Auctions are appropriate where you are buying a product which is very standardized like sugar say, from multiple suppliers. They are not appropriate for the strategic sourcing of differentiated services where suppliers have specialized capabilities such as outfitting a hospital, and few suppliers can meet quality and reliability standards. In these strategic situations on-going relationships and multi-faceted tendering are key, not single auctions and bids largely based on the pricing of a complex set of requirements.

Auctions do not help buyers and suppliers solve problems jointly, indeed they are often toxic for buyer-supplier relationships which are not great if you are stuck with each other for twenty years. General Electric once claimed that it saved $600m a year using electronic reverse auctions but later studies found that 50% of their savings disappeared later because of factors such as errors in supplier data, post-auction negotiation, changes in the specifications and quantities. Further savings were lost from poor quality, late deliveries and supplier non-performance.

They key thing is to have a tender process that is focused on service not price. Governments will deny that service is not key but my point is that the moment the government has a long long list of requirements for the building and operation of a hospital or a school and asks for the lowest, qualified, bidder who would meet these requirements. Again the government's objective is to get something for less. All the innovation of the market is geared towards providing some existing and perhaps not particularly satisfactory service, at a cheaper cost. In this situation there is almost no other room for a private sector company to make money from this process except by squeezing its employees and surreptitiously skimping on your product. A PFI hospital in this set up will always be uncomfortable to stay in, if they ever let you stay in a bed, and unsatisfying to stay in.

Instead, the government should say to the qualified bidders, here is how much I will spend; it's the same as I used to spend with perhaps an annual increment for inflation. Tell me what services and to what measurable quality, you will deliver for this amount of money. In this case, the markets creative forces are unleashed not in the narrow and soul destroying area of cutting labour costs, but in finding ways of improving services and customer satisfaction. And one of the key ways to improve service is to invest in your staff and to understand your customers.

To conclude there is a right way for government to really partner with the private sector and there is a wrong, illusory and potentially harmful way.

The private sector cannot make capital projects cheaper than if the best credit in the land borrows the money itself. But the private sector is better at innovating than the public sector, so give it the room to innovate….not by asking for the cheapest way to achieve the previously unsatisfactory level of service through an auction…but by saying here is my transparent economic commitment to this project, tender to me how you would best improve the service we offer to our customers. This change at the centre of the process will require three institutional changes. First a move a way from price based auctions to fixed-price, service based tenders; second, independent assessments of customer satisfaction and professional achievement – it is possible that patients are very happy with the hospital, but it just isn't delivering the best medical care. Third, clear and tough penalties need to be in place, especially for behaviour that could cause harm. Example of this could be the establishment of corporate killing as an offence and making individuals even more responsible for the activities of the companies they run and own.

Public finance and private delivery has been set up to date as a way of trying to get something for nothing, as a way of saving costs, breaking the hold of unionized public sector workers, and spending money that you do not account for. In this regard the benefits are illusory. What public finance and private delivery can achieve is to unleash the creative forces of the market in delivering choice and customer-centric, public services, financed by the tax payer. It should not be a way of sneaking an extra school building in before the election and not accounting for its costs, but helping our schools and hospitals and social housing to a higher standard. For all the soul searching about public private partnerships, we have not yet begun to do this.