

# PAYBACK TIME FOR THE PFI?

Words: **Mark Hellowell** | Photography: **Lores**

*For two decades the PFI has been the only game in town for financing public infrastructure. Now pressure is mounting for the private firms that have done so well out of it to put something back into the public coffers*

**THE LAST LABOUR** government was a big fan of the Private Finance Initiative. As chancellor, Gordon Brown would castigate the PFI's critics for putting new hospitals, schools and transport projects at risk. The alternative, he said, would be 'reckless and unsustainable borrowing'.

But, as many pointed out at the time, the PFI is itself a form of borrowing, even if its impact on the national statistics is deferred. While upfront capital is provided by private investors, the taxpayer ultimately funds the whole cost of any project. Now, that essential truth is becoming evident in communities across the country.

Take the £256m Queen Alexandra Hospital in Portsmouth. This sparkling new facility was officially opened in October, and is undoubtedly one of the most impressive health care buildings in Europe. But the Portsmouth Hospitals NHS Trust is already struggling to meet the project's £40m annual revenue cost. Its ability to pay was premised on achieving epic savings targets and big increases in activity, which failed to materialise. As a result, the trust has been forced to take out a £13m loan to pay its bills, while

cutting 700 jobs and 100 beds. It is left with a £6m deficit and many more job losses are expected soon.

Yet the scheme has proved profitable for the investors (see box overleaf). Last June, Carillion, a construction group, sold its shares in the project to HSBC Infrastructure Company Ltd for £31m – a healthy return on the £12m it put into the deal in 2006. It will, meanwhile, continue to manage the new PFI facilities under a concession worth about £30m a year.

Answering a question on the Queen Alexandra deal in Parliament recently, Prime Minister David Cameron called the PFI programme a 'shambles' that he had inherited (although he was special adviser to Tory chancellor Norman Lamont in 1992, when the PFI was introduced). Cabinet Secretary Francis Maude described PFI profits as 'outrageous' last month. The anti-PFI rhetoric is becoming more strident even as ministers approve huge new projects – the Royal Liverpool Hospital, signed off by Health Secretary Andrew Lansley in June, will be one of the largest PFI hospitals ever procured.

Ministers are trying to get equity



**'WE NEED A DEAL WITH ALL THE MAJOR PFI FIRMS'**

JESSE NORMAN MP  
HEAD OF PFI REBATE CAMPAIGN



**Behind the facade:** the new Queen Alexandra Hospital in Portsmouth might be an attractive building but its costs are plunging the trust into ever deeper debt

owners of PFI projects to sign up to a new code of practice on the governance of operational contracts. The principles have been outlined in draft guidance issued by the Treasury, and are to be piloted on the Queen's Hospital PFI project in Romford.

The pilot, to be completed later in the spring, will identify the current levels of service and how these might be amended, and how savings can be made without renegotiating the contract. It has been chosen, according to officials, because it is regarded as representative of the broad population of PFI contracts for accommodation facilities.

While the scope of the pilot is limited, the choice of the hospital sector is interesting. In November, Peter Coates, the Department of Health mandarin who managed the hospital-building programme for more than a decade under Labour, told the Commons' Public Account Committee that the prices paid for many PFI hospital deals had been too high, reflecting the 'overheated' state of the market.

Much of the Conservative-supporting press has eagerly reported stories

of government-commissioned 'crack teams' tearing up contracts signed by bungling Labour ministers. In reality, however, the scope of the code of practice is likely to be modest and will leave most PFI contracts inviolate.

Announcing the Romford pilot in February, Treasury minister Lord Sassoon said the proposals would 'drive out costs while ensuring frontline services are maintained'. In private, however, Treasury officials insist they will do precisely the opposite. Officials expect a maximum of 2% to be shaved off the cost of contracts, and they stress that even these modest savings will be achieved, not by asking investors to take a profit margin 'haircut', but by cutting back on the quantity and quality of the services they are contracted to provide.

Investors do not regard the code of practice – or the broader Cabinet Office review of large contracts that followed Sir Philip Green's public procurement report – as serious threats to profitability. It is certainly striking that no large provider to government has yet issued a profit warning as a direct result of the

review of large contracts. Carillion, for example, has said actions agreed with ministers as part of the broader review of contracts would have 'no material impact' on its profitability.

Similarly, Capita, the UK's largest public sector outsourcing group, insists that the review will have no immediate effect on profits. It believes that orienting the quality and quantity of its services towards a 'more appropriate standard' will be the main way of saving money.

Much of the impetus behind the current review of PFI contracts has come from the cross-party 'PFI rebate' campaign, which is led by the cerebral and independent-minded Conservative MP Jesse Norman. And it is this campaign that is likely to put pressure on ministers to shift from cautious tinkering to a more inclusive review of the relationship with investors. It has already made its presence felt in Parliament, and was influential in establishing a Commons Treasury select committee inquiry into the PFI, which will begin taking oral evidence in a few weeks.

Speaking to *PF*, Norman welcomed the Treasury's plans for the PFI code



**Speeding ahead:** new transport links are being pushed through under the PFI

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of practice, but he believes the current proposals fall well short of the full rebate that MPs are calling for. He says the campaign will continue to push for 'a much more comprehensive deal with all the major PFI providers'. He insists that with 69 MPs the campaign is 'still in its growing phase' and will expand in numbers and influence over the coming months.

Of the various potential sources of 'rebate' for the public sector, two stand out as the most practical and productive. The first is to ensure that the amount of money PFI consortiums spend on maintenance is subject to regular reviews, and that providers are forced to identify opportunities for sharing any resulting gain with the public sector. Maintenance is the main function performed by PFI contractors once the buildings are completed, and is provided on a monopoly basis – by the investor companies themselves – throughout the whole contractual period.

On many deals, projections of maintenance expenditure made when contracts were signed have proved excessive. In turn, this has meant that the annual charges being paid by public authorities are at a much higher level than is necessary to reimburse PFI providers for their operational costs. Currently, this surplus cash flows directly to investors – and there is, as yet, no way for the public sector to claw any of it back.

The other promising rebate idea relates to the PFI's secondary market, in which equity investors sell their shares

after the risky construction period, as Carillion did with the Queen Alexandra Hospital. Amyas Morse, the head of the National Audit Office, argued in a recent committee hearing that the secondary market was profitable and 'there might be a case for [the government] to capture some of that gain'.

There is a precedent for this approach, in that PFI investors are expected to share with the public sector any windfall gains generated through refinancing their bank loans. But the Treasury has long resisted this, fearing it will reduce the liquidity of equity as well as trust in the market. According to a Treasury official, equity sales are 'something to keep an eye on', but there is as yet no 'active review' in relation to gain-sharing.

In fact, the Treasury has long since taken its eye off this particular ball. Its database of investors in PFI projects was last updated in February 2009 (and it was not very accurate even then). However, a record compiled by the independent European Services Strategy Unit records 222 equity transactions in the secondary market, relating to assets valued at almost £4bn.

The compiler of that database, Dexter Whitfield, claims that the average profit realised by vendors across the market was 50.6%, and amounts to half a billion pounds overall. Whitfield also suggests that a great majority of equity assets bought through the secondary market are held by companies based offshore.

The government seems to regard

these rebate options as unrealistic. With government capital spending set to fall by an unprecedented 59% over the next five years, from £49bn in 2010/11 to £20.6bn by the middle of the decade, ministers have no strong incentive to antagonise PFI sponsors or other investors. Chancellor George Osborne's Comprehensive Spending Review speech last year promised to 'avoid the errors' of the early 1990s by slashing spending on new capital investment. However, the reduction in capital budgets that occurred in the early 1990s was significantly less radical than the one outlined in the Review documentation. The chancellor must be looking to the private sector to finance this huge shortfall in capital investment.

A closer look at the reality on the ground reveals that this is exactly what is happening. PFI projects are being allowed to proceed to financial close, and business cases for new projects are being signed off. Lord Sassoon, in a speech to the annual dinner of the Public-Private Partnerships Forum lobby group in November, confirmed that the government remained committed to the PFI, and that such arrangements would continue to play an important role.

The pipeline of PFI schemes approved by central government is growing again after a period of hiatus. Transport Secretary Philip Hammond gave the go-ahead for the Intercity Express Programme and the second phase of the Nottingham tram scheme in January. Contracts for legacy projects under the Building Schools for the Future programme continue to be signed (and some less advanced schemes may re-emerge after their cancellation was judged illegal by the High Court in February). In any case, Education Secretary Michael Gove's antipathy towards

## Private finance, public deficit? The case of Queen Alexandra Hospital

The £256m Queen Alexandra PFI Hospital in Portsmouth was completed in July 2009, and opened by Princess Anne in October. But the trust has struggled to meet the annual revenue cost of the deal.

Chief executive Ursula Ward has said that despite cutting 700 jobs and closing wards, an extra £30m will have to be saved in the next financial year.

A peculiar feature of the Queen Alexandra PFI is the use of 'credit guarantee finance', in which 91.5% of the money to build the scheme actually came from

the public sector, rather than the banks or commercial bond issues that normally finance these projects. Although the finance was public, it was guaranteed by a private sector insurer, and priced on the basis of 'contemporary market norms' – ie, well above the rate at which the government can borrow on its own account.

The difference between the government bond rate and the loan rate is, in effect, profit for the Treasury. But neither the Department of Health nor the trust gains from this arrangement, in terms

of lower annual charges, compared with purely private PFI schemes.

Last June, Carillion sold its shares in the hospital to HSBC Infrastructure Company Ltd for £31m. Carillion, which had invested £12.1m in the deal, earned £31.3m from the sale.

HSBC bought a further 15% of the scheme from Royal Bank of Scotland for £13.4m in October, and now owns 89.9% of the equity and 100% of the loan note interest.

It expects to earn £160m from the scheme over the remaining 30-years of the contract.

the BSF was unrelated to the PFI's key role within it. The Department for Education will reveal a new private finance model for the free schools programme later this year.

In the health sector, six schemes totalling £2bn are currently being procured, including two large Merseyside schemes and projects in Papworth, Stanmore, North Tees and Sandwell. Lansley scrapped Labour-approved plans for a publicly funded hospital in Hartlepool last year, claiming it was unaffordable. But the trust will shortly seek approval for a new business case, this time on a PFI basis.

The gap between the Westminster government's rhetoric and the reality on the ground corresponds almost exactly

with the situation north of the border. At the Scottish National Party conference on March 12, First Minister Alex Salmond castigated the previous administration for landing the SNP government with an annual PFI bill of £800m – a 'toxic Labour legacy', as he described it.

But Holyrood is now planning to add significantly to this bill, with a £2.5bn programme of new schemes in health, transport and education. These will be structured according to the so-called 'non-profit distributing' version of the PFI, which was introduced by the previous Labour-Liberal Democrat administration in 2003. This involves the private sector earning its money as a return on loan stock, rather than a dividend on share capital, hence the 'non-profit' tag, but its long-term cost to taxpayers is similar to that of the classic PFI model.

In recent years, the public's view of the PFI has deteriorated rapidly. Nobody talked up their commitment to the scheme in the last general election. Politicians in Westminster and Holyrood have learned that it is preferable to continue with private finance to plug the capital shortfall while apparently doing the opposite. As long as this remains the case, investors will have the upper hand in negotiations. Payback time for PFI contracts is still a long way off.

**FIRST MINISTER  
ALEX SALMOND  
CASTIGATED  
SCOTLAND'S  
ANNUAL £800M PFI  
BILL – BUT NOW  
PLANS A FURTHER  
£2.5BN WORTH OF  
SCHEMES**



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