Public Works Financing

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Balfour Beatty on PFI Reform

EXECUTIVE SUMMARY

1. PFI has delivered significant benefits by creating a framework which allows considerable investment in our national infrastructure, including a large building programme of new schools and hospitals. However the industry should recognise that there is significant scope to improve the partnership with the public sector and should positively engage with the Government as they seek to do so.

2. Balfour Beatty has proposals to help the Government improve PFI and strengthen the partnership between the public and private sectors, so that it can continue to invest in vital infrastructure and deliver the benefits of PFI whilst reducing costs and eliminating some of the problems. At the same time as recommending changes from the public sector, we recognise that the challenge of improved efficiency is also incumbent on the private sector who need to play their part in delivering more for less.

3. We believe that a model which involves the private sector raising finance to deliver public infrastructure is worth continuing as part of a range of procurement options, provided that the cost of private finance is outweighed by the benefits of applying whole life costing and private sector procurement and management skills to projects.

4. Areas the Committee may wish to explore in terms of the possible reform of PFI include:

— The efficiencies to be made from changing costly, complex and lengthy procurement processes.

— Savings to be made by avoiding the transfer of inappropriate risks.

— Finding a means of injecting greater flexibility into the system.

5. As Government moves from the present model of PFI to a reformed model for financing infrastructure, it is imperative that we maintain investment levels. Sustained investment in our infrastructure is vital to the future of the economy and the country and any hiatus would be particularly damaging in the present economic environment.

FUNDING INVESTMENTS IN INFRASTRUCTURE IS VITAL TO THE FUTURE OF THE ECONOMY

6. Balfour Beatty believes that sustained investment in infrastructure is vital to the future of the economy. From 1999-2008, UK public investment as a percentage of GDP was lower than almost any other OECD country[3] and almost half the average of G7 countries. Although fiscal restraint is a national imperative, it is clear that there is a positive relationship between infrastructure spend, the level and growth of GDP and stock market indices.

7. In particular, investment in infrastructure has a higher economic multiplier than other types of government expenditure. Against other forms of spending, investment in infrastructure can be said to produce:

— low reliance on imports thus resulting in greater additional economic activity in the UK;

— a heavy reliance on an extended and varied supply chain, thus engaging many different parts of the domestic economy; and

— high levels of employment due to the labour intensity of the work.

8. To curtail infrastructure spending severely will produce undesirable outcomes. HM Treasury's recent Infrastructure Cost Review concluded that the *"Stop-start investment programmes and the lack of a visible and continuous pipeline of forward work"* was a key driver of higher cost. Furthermore, uncertainty regarding future infrastructure spend creates a supply chain reluctance to invest and a loss of skills and expertise which will be difficult to reassemble.

9. For these reasons, we believe that as the Government considers the future of PFI it is imperative that any potential new funding model not only sustains, but if possible increases, the overall level of public investment. Moreover, should there be a transition from the present PFI model to an alternative involving private finance, it is imperative that there is no hiatus in infrastructure investment.

PFI STRENGTHS AND WEAKNESSES

10. PFI has been a significant part of the UK's procurement model since 1994 accounting for up to 10% of public infrastructure procurement. In that time a significant number of independent reports have been produced, notably from the NAO, highlighting benefits including:

— Facilitating £28bn of public investment, including large scale school and hospital building programmes.

— As the recent Lords Select Committee concluded, *"There is strong evidence that PFPs have a better record of on time and on budget delivery than traditionally procured projects".*

— Integrating design, construction, and operation into a single framework leading to efficiencies of whole life costing - as highlighted by a 2003 NAO report on PFI Construction Performance.

— Facilitation of strong customer service orientation through incentives, leading to increased user satisfaction as evidenced by the 2009 NAO Report on PFI which reported high levels of satisfaction from PFI customers.

— A management process that allows the public sector to focus on outcomes rather than requiring it to be involved with the framework of delivery.

11. Against these claims have been criticisms. First, that the process is "expensive" and can be replicated without the use of private finance. Secondly, the length and complexity of the tender process leads to, as well as cost, unnecessary delay. Lastly, that the structure of PFI, with multiple stakeholders and an elaborate governance process, leads to inflexibility, thus restricting the accommodation of progress and change within a long term contractual arrangement. The latter two of these points are undoubtedly true and we suggest solutions for this in the latter part of our submission. The first of these points is complex and benefits from some analysis.

12. The claim that PFI is "expensive" could be based on the following arguments:

— that the elemental cost (principally construction and facilities management cost) is expensive; and/or

— that the risk transfer leads to costs that are not value for money; and/or

— that the cost of finance is expensive.

13. There is no evidence to suggest that the elemental cost of a PFI project is any higher than that of a project procured under a different model. Therefore, we intend to focus on the other two elements - risk transfer and financing costs.

14. In relation to risk transfer, it has become clear over the years that, at times, the tax payer is paying for unnecessary elements and savings can be made. We offer solutions below.

15. The financing costs of PFI are typically 3-4% over that of government debt. The question of whether or not this represents value for money is a value judgment for Government, and this judgment needs to take into account the savings PFI can help to deliver elsewhere in the procurement process, notably in terms of on-time and on-budget delivery, risk transfer, and whole-life management of infrastructure assets. The following paragraphs consider those benefits in more detail.

16. The key benefit of PFI to the public sector is that it transfers whole-life risk from the public to the private sector. As such, the company building the asset is very strongly incentivised to build a piece of infrastructure which is high quality not just on day one, but for up to 30 years later. For a PFI provider the main costs of construction are up-front, but it recovers that investment with payments staged over that 30 year period

and dependent on performance. Without the use of private finance (were the public sector to fund the up-front capital cost itself for example) it would be impossible to transfer risk in this way and incentivise performance over a 30 year period.

17. A second key benefit of PFI is that it allows world class construction management to be brought in to manage public infrastructure projects without the duplication and man-marking which often occurs when the public sector "manages" a construction contractor in a traditional model. As the James Review into Building Schools for the Future (BSF) sets out, these sophisticated construction management skills are seldom present in the public sector, with the review concluding that *"A lack of expertise on the client side meant that there was little opportunity to improve building methods in order to lower costs over time, especially for very large and complex projects."*

18. Proving whether the two key benefits of PFI - risk transfer and more efficient project management - outweigh the additional financing costs has so far proved difficult. Although projects funded by PFI have detailed performance data, one of the missed opportunities over the period has been a failure to utilise similar systems of measurement of performance where the public sector itself manages its own assets.

THE FUTURE OF FUNDING INFRASTRUCTURE

19. The arguments articulated above lead to the following basic conclusions:

— A model which involves the private sector raising finance to deliver public infrastructure is worth continuing as part of a range of procurement options provided that the incremental cost of private finance is outweighed by the benefits of applying whole life costing and private sector procurement and management skills to projects.

— PFI value is diminished by costly, complex and lengthy procurement process.

— PFI value is also diminished by transfer of inappropriate risks.

— A means of injecting flexibility into the system needs to be found.

These issues are examined in turn.

TIMESCALES

20. Often, lengthy procurement programmes coupled with delay during the competitive dialogue process adds to cost. The James Review in fact reached the same conclusion, stating, *"The extremely lengthy pre-procurement and procurement processes were a key driver of both cost and, crucially, risk for the Local Authority, central government, and the private sector. The increase in risk was costed in to every stage of every project by each contractor and sub-contractor."* It seems to us that the principal causes of both the length of programmes and their subsequent delay are lack of preparation by the contracting authority prior to commencing the dialogue process and also changes in personnel or policy during the dialogue process.

21. Balfour Beatty's recommendations for reducing timescales in procurement are:

— No more than 3/4 bidders should be pre-qualified so that the client has sufficient time to conduct dialogue with shortlisted bidders at the preliminary stage.

— Authorities should reduce to 2 bidders as quickly as possible - in most cases we believe that this can be achieved in 4 months from shortlist by ensuring that there are no more than 2 stages to any procurement process after short listing.

— Authorities should tighten authority evaluation periods post-submission by better use of project management.

— We believe that these changes would make the market even more competitive by encouraging potential new entrants, by reducing the sometimes onerous bidding costs.

PROJECT MANAGEMENT

22. Balfour Beatty's experience coincides with several reports into the procurement and management of PFI projects, in particular the recent James Review of BSF that has highlighted weak project management by authorities as a major concern. This is often a function of inexperienced public sector managers, coupled at times with a structural weakness where, in some sectors clear and effective project management is prevented by the plethora of external agencies and experts that are required to be engaged on the client side.

23. Balfour Beatty's recommendations for improving authority project management are to:

— Identify, develop and career plan for effective authority project directors/managers, inter alia by the provision of development programmes.

— Reduce the frequency of key personnel changes during procurements.

— Appoint single sources for professional advice to ensure clarity of message to bidders.

SCOPE

24. The scale of PFI projects, their long-term nature and the number of participants necessarily involved in any PFI contract makes these projects complex. In these circumstances it is paramount for the authority to simplify the technical and commercial arrangements for the project as far as possible. In our experience, the more complex the scope of a project the more likely it is to suffer delays in procurement and to suffer from a lack of clarity about what has been agreed when it comes to the operational stage of the project.

25. Balfour Beatty's recommendations for ensuring an effective and efficient project scope are to:

— Avoid the temptation to "integrate" projects in the hope that this will transfer interface risk from the authority to the private sector. In our experience such attempts (eg including ICT under contractors' control in BSF projects) leads to complexity, delay and cost compared with the alternative of the authority managing this co-ordination.

— Ensure that where multiple authorities collaborate to deliver "bundled projects" (which we support - see below) there are effective governance arrangements in place such that the private sector deals with one lead organisation.

— Evaluate more carefully whether there is value for money in transferring existing assets to the private sector as part of the PFI transaction and, where existing assets are to be transferred, ensure that surveys are procured *before or at the earliest stages of procurement* which enable the private sector to assess risk.

COSTS

26. The cost of procurement is affected by all these issues: timescales, the calibre of project management and project complexity. In Balfour Beatty's experience there are a number of other areas which significantly add to the cost of procurement or where procurement costs can be reduced.

27. Our further recommendations for reducing the cost of procurement are to:

— Avoid the use of PFI for smaller projects where the transaction costs of PFI do not represent good value for money. It needs to be considered case-by-case, but as a ballpark figure we think PFI should be avoided for projects of less than £20 million.

— Increase the efficiency of procurement and reduce transaction costs by "bundling" PFI projects so that only one project is designed but multiple projects awarded. "Bundling" projects in this way can be an effective way of delivering similar projects across multiple authorities (eg in Fire & Rescue) providing they have previously set up a single procuring organisation (as noted above).

— Develop standard designs or standard design elements where appropriate. Standardisation was a key finding of the HM Treasury Infrastructure Costs Review, which concluded that "Over-specification and the tendency… to apply unnecessary standards, and use bespoke solutions when off-the-shelf designs would suffice" was a key driver of increased costs.

BALANCING RISK TRANSFER WITH VALUE FOR MONEY - PAYMENT MECHANISM

28. Balfour Beatty's experience across a wide range of PFI sectors is that clients, often encouraged by their external advisory teams, are tempted to incrementally increase the risk transferred to the private sector. Often, these increases in risk transfer are not properly evaluated in terms of the potential impact on value for money. The payment mechanism is the authorities' main commercial tool to incentivise performance against the expected standard. However, our experience is that over time, increasingly aggressive payment mechanism arrangements result in poor value-for-money as PFI operators build-in risk to avoid the consequences of disproportionate penalties. Balfour Beatty's recommendations for improving the payment mechanism are to simplify the number of performance measures and put operational management in the lead of payment mechanism deliberations rather than them being led by financial/legal advisors.

OTHER RISK TRANSFER ISSUES

29. Similar to the payment mechanism, other risks have been pushed to the private sector side either in the standard form contracts or as a result of "risk-creep" in various PFI sectors. Balfour Beatty makes a number of recommendations aimed at re-balancing this risk transfer to ensure improved value for money:

— *Insurance*. By requiring the private sector to insure PFI projects the public sector is building in the cost of premiums into PFI charges which significantly exceed the cost of claims. Public sector self-insurance, particularly for material damage and business interruption insurance, could provide significant savings on future projects.

— *Energy*. The public sector should resist the temptation to attempt to transfer risk on tariff which the private sector cannot manage any better than the public sector. Procurement of energy must be more effectively managed by the public sector, which can achieve significant economies of scale compared to the private sector.

— *Pensions*. The temptation to transfer existing public sector pension risk to the private sector should be discouraged. Some authorities attempt to use the opportunity of a PFI project to pass existing pension under-funding and future liabilities to the private sector which is unable to do anything material to manage this risk and consequently prices it in to the detriment of value for money for the public sector.

— *Demand risk*. Except where the private sector is genuinely responsible for generating customers/users, the transfer of demand risk (eg traffic counters on highways projects) should be avoided. Demand risk tends to increase the cost of lending and result in a sub-optimal project structure which leads to a reduction in value for money for the public sector.

IMPROVED EFFICIENCY FROM THE PRIVATE SECTOR

30. Balfour Beatty recognises that there is considerable scope for the private sector to improve its efficiency when delivering PFI projects, savings which can be passed back to public sector clients. We believe that more use could be made of techniques to drive efficiency in the construction and operations phases of PFI projects. Eg making more use of innovative techniques such as off site system build and assembly can save significant sums through the construction phase. With a sufficient pipeline, economies of scale can be delivered through efficient purchasing techniques (bulk purchasing or on-line auctions, for example) throughout the supply chain, which guarantee quality as well as price. Similarly, the private sector could be incentivised to produce year-on-year savings throughout the lifetime of infrastructure projects by driving continuous efficiency improvements to reduce costs.

BALFOUR BEATTY

31. Balfour Beatty is a British infrastructure company founded in 1909, employing over 50,000 people around the world including over 30,000 in the UK. We deliver services essential to the development, creation and care of infrastructure assets including project design, financing and management, engineering and construction, and facilities management in sectors including transport, power, waste and buildings.

32. Balfour Beatty has been a contributor to the development of PFI in the UK and increasingly overseas. By the end of 2010 Balfour Beatty had invested in over 50 PFI concessions world-wide committing well over £500 million of equity.

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