

# **PRIVATE FINANCING OF PUBLIC ASSETS**

## **Practical and Policy Problems**

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# 1. The Background to Private Finance

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- 1.1 This part reviews the nature of the historic procurement problem for which the private financing of public assets was seen as a solution, and outlines the current nature and scale of the UK's private financing programme (commonly called the Private Finance Initiative, or PFI).

## *The Historical Problem of Public Procurement*

- 1.1 The development of private finance as a means of procuring public assets stems from the perceived weaknesses of past public procurement. The historic record of public procurement in the UK shows that new public assets procured under traditional procurement methods were often delivered late and over budget, with the consequential financial costs being borne by tax payers. Examples in the UK are:

- (a) The London Underground Jubilee Line Extension was delivered two years late at a cost of more than £1.4 billion over its original estimate.
- (b) The 25 largest equipment projects in the Ministry of Defence experienced cost overruns amounting to £2.8 billion with an average delay of 3½ years.
- (c) A 1999 study of central government construction projects found that in 73% of central government's construction projects the price to the public sector exceeded the contractor's tender price and the project ran over the public sector's budget, and only 30 per cent of conventionally procured major construction projects were delivered on time.<sup>1</sup>

- 1.2 The general trend in relation to traditional public procurement has been summarised as:

*“tending to be deficient in appreciating risk and as a result budgets for major procurement projects have sometimes been prone to optimum bias, i.e. a tendency to budget for the best possible (often lowest cost and earliest completion) outcome rather than the most likely. This has led to frequent cost and time overruns. Optimism bias has also meant inaccurate prices have been used to assess options. Such biased financial (i.e. price) information early in the budget process can result in real economic costs resulting from inefficient allocation of resources.”<sup>2</sup>*

- 1.3 Private financing was developed in the UK as a specific response to these concerns. Under private financing the public sector contracts with a private sector entity for the financing and delivery of public services in accordance with specified “output” requirements for a limited contract period. A privately financed project differs from conventionally funded capital projects in a number of fundamental ways:

- (a) The private sector not only constructs assets but is responsible for financing and undertaking on-going operation and maintenance: the public sector effectively pays for a serviced facility rather than “owning” and controlling the asset and the method of service delivery. By contrast, under a conventionally procured project the capital cost of a facility (i.e. its construction cost) is paid directly by the public sector as the principal under a construction contract.

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<sup>1</sup> “Benchmarking the Government Client Stage 2 Study – Agile Construction Initiative”, December 1999, cited in National Audit Office, “Modernising Construction”, 11 January 2001, HC 87 2000-2001, 2.

<sup>2</sup> HM Treasury, “How to Construct a Public Sector Comparator (Technical Note No. 5)”, para 2.4.3.

- (b) An “output” specification is at the centre of the public sector procurement process. Under this specification the public sector client specifies its requirements in terms of the required level of service or asset performance, and it is up to the private sector to bid on the basis of the solution it considers will best meet those service requirements. This can be contrasted with certain forms of public sector procurement where the method of service delivery and the “inputs” used to deliver that service are specified by the public sector, and the private sector simply prices against that specification.
  - (c) The public sector pays a fee to the private sector in return for services over the period of the PFI contract, which could be up to 30 years. However the capital cost of the asset is only a part of the total cost of a privately financed project: the fee also covers the capital costs, financing and operating costs of the private sector service provider, but always remaining subject to adjustment to reflect the actual level of service delivered.
- 1.4 It is also useful to note the ways in which private financing differs from other models for private sector participation in public service provision. Private financing differs from:
- (a) privatisation, in that the public sector retains a substantial role in privately financed projects as the purchaser of services;
  - (b) contracting out, in that the private sector provides the capital asset as well as the services; and
  - (c) other forms of Public Private Partnership (PPP), in that the private sector contractor also arranges finance for the project.
- 1.5 The use of private financing, and the nature of contracts whereby there is a substantially enhanced transfer of construction and operational risk to the private sector, entails a new and specific allocation of risk between the private and public sectors. The public sector retains some of the risks it would normally assume in a conventionally procured project but it substantially transfers the remainder to the private sector. The private sector therefore takes on those risks that it is judged better able to manage, like design, construction and maintenance risks, and so that it is better incentivised to perform. A financial cap to the risk assumed by the private sector is the value of the debt and equity it provides to the project.
- 1.6 Key retained public sector risks generally include:
- (a) the need for the facility on the date given and the adequacy of its overall size to meet public service needs;
  - (b) the possibility of a change in public sector requirements in the future;
  - (c) whether standards of delivery set by the public sector are sufficient to meet future public needs;
  - (d) the extent to which the facility is used or not used over the contract life; and
  - (e) general inflation risks (unitary charges typically being linked to inflation and so are subject to same inflation risk as future maintenance or other costs in conventional procurement).<sup>3</sup>

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<sup>3</sup> For risk allocation and public sector protections generally in a privately financed transaction see HM Treasury, “PFI – Meeting the Investment Challenge”, July 2003 at paras 3.29-3.33.

1.7 Risks which are transferred to the private sector generally include:

- (a) the requirement to meet the required standards of service;
- (b) cost overrun risk during construction;
- (c) timely completion of the facility;
- (d) changes in the underlying costs of service delivery and future costs associated with the asset;
- (e) the risk of industrial action or physical damage to the asset; and
- (f) in certain cases, demand risks associated with the scheme (such as the project revenue generated by shadow or actual tolls in the context of a road project).

This statement regarding the transfer of risk to the private sector is however subject to the caveat that for certain risks there may be mechanisms which mitigate the private sector's exposure to that risk.<sup>4</sup>

1.8 In order to protect the public interest in respect of the continuing and effective delivery of public services there are a number of safeguards available to the public sector:

- (a) If the private sector fails to deliver the project on time, or the services provided are below standard, deductions and penalties will be withheld from payments made by the public sector. The potential loss of revenue resulting from deductions and penalties therefore provides a powerful incentive for performance.
- (b) The public sector retains the right to step in and take over the operation of the services if there is a serious risk to health and safety, serious risk to the environment, to exercise its statutory responsibilities or if the project has national security implications.
- (c) Where there is a continuing default the public sector has the right to terminate the contract and step in to ensure continuity of service delivery. In these circumstances, projects will revert to public ownership, including the transfer of assets and staff necessary to continue to deliver service, and compensation may be due to the private sector.<sup>5</sup>

1.9 Private financing is seen as a solution to public sector procurement problems on the hypothesis that it will deliver price certainty and timely delivery of good quality assets. This hypothesis has a number of foundations and features:

- (a) The transfer of completion and operational risk to the private sector is considered crucial to the benefits offered by private financing, both by incentivising projects to complete on time and on budget and to take into account the whole of life costs of an asset in its design and construction.
- (b) The inherent involvement of third party (bank) finance in private sector financing brings with it extensive due diligence to identify, allocate and price project risks. Because project lenders have money which is at risk in the project they will be

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<sup>4</sup> An example is periodic benchmarking of certain project costs or, in a toll road project, a toll adjustment mechanism.

<sup>5</sup> The termination compensation scheme in a privately financed project is relatively complex and is discussed below.

concerned that the private sector contractor makes appropriate risks allowances in its pricing. Pre-contract scrutiny of projects by external funders is therefore an important factor in increasing the likelihood of privately financed projects being delivered on time and to budget.

- (c) Private financing means that the same parties are potentially involved in a long term relationship over the whole contract life. Shareholders therefore have a long-term financial interest in the project, as contrasted with traditionally procured assets where construction companies usually have no interest in the long-term performance of the asset. Whole life asset costing can lead to higher construction standards in order to reduce the need for long-term maintenance throughout the contract, therefore reducing the risk of payment reductions due to unsatisfactory service. Contractors are also incentivised to deliver the required level of service over the whole life of asset as the private sector only gets paid if it maintains standards throughout the length of the contract, and the greater of the private sector equity return will be derived from the latter part of the contract period (the project "tail") when debt repayment obligations have been satisfied. Under private financing the private sector's capital (not just its profit) is at risk of project performance, and this is a strong incentive for the private sector to maintain high service standards throughout the life of the contract.
- (d) The service payment commences only on completion. The private sector is incentivised to estimate the full costs of construction, including allowances for risks, as it will not be able to recover unforeseen cost increases by claiming them back from the public sector as under a traditional form of procurement.
- (e) By allowing the project's cost of capital to reflect the perceived risks in the project, and not simply the balance sheet strength of the entity procuring the finance, private financing assists the public sector by providing a more explicit assessment, allocation and pricing of project risk.<sup>6</sup> This is perceived as offering a systemic benefit, even if a project's financial assessment does not show an advantage in the privately financed provision of the service in question. It also allows a better understanding of total costs of providing the required service. The public sector can clearly define at the start the service it requires. The private sector partner gives a price for the total cost of that service covering both the up front cost of new investment and ongoing cost such as maintenance, helping to avoid short-term focus and emphasising the long-term needs of the public sector.

#### *The Current Status of Private Financing in the UK*

- 1.10 The PFI in the UK largely stems from the work of the Private Finance Panel on behalf of HM Treasury, whose role was to encourage greater participation in the initiative by both public and private sectors and to identify new areas of public sector activity where the private sector could get involved. In May 1997 the Paymaster General announced that Sir Malcolm Bates would review the PFI process. The first review by Sir Malcolm Bates published in June 1997 made recommendations to streamline and improve the delivery of PFI projects. One recommendation was the creation of a PFI task force inside HM Treasury. In September 1997 the Treasury Taskforce became the focal point for PFI activity across government, charged with publishing a series of guidance documents, policy statements, technical notes and case studies. A second Bates review was published in July 1999 and recommended that a permanent organisation, Partnerships UK (PUK), be formed to replace the Treasury Taskforce. PUK, eventually itself a PPP between the private sector and the public sector, replaced the executive arm of the Treasury Taskforce. It works with both public and private bodies on privately financed transactions to improve the planning, negotiation and execution of privately financed transactions.

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<sup>6</sup> HM Treasury, n 2 at para 2.4.10.

1.11 Total UK government investment has increased significantly since 1997 and the UK's PFI program has gathered pace in line with it. A total of 563 PFI transactions had reached financial close by 4 April 2003, with a total capital value of £35.5 billion and with £32.1 billion of that investment committed since 1997. PFI investment from 1997 to 2001 has averaged £2.6 billion a year. PFI Investment has been used across a range of sectors:<sup>7</sup>

- (a) the Department for Transport accounts for 22 per cent of projects by capital value;
- (b) the Department of Health has seen total capital investment of £3.2 billion with 117 PFI projects signed;
- (c) the Department for Education and Skills has seen 96 transactions worth £2 billion; and
- (d) the Ministry of Defence has seen 46 transactions worth £2.5 billion.

1.12 The UK government publishes estimates of payments under all the signed PFI contracts in the Financial Statement and Budget Report. PFI payments cover the private sector's cost of capital, interest rate hedging costs, services need to run and repair that asset, maintenance and "soft services" such as cleaning and catering. In a typical PFI hospital payments for services make up 40-50 per cent of the unitary charge, while for a typical PFI school project around 30 per cent of unitary charge goes towards soft services. If a project is procured by conventional means these future costs for services are not automatically, monitored or disclosed. Reporting of payments under PFI contracts therefore provides a fuller picture of future commitments than would be possible under conventional procurement and better information for the management of future budgets.<sup>8</sup> It is noteworthy that the majority of privately financed projects by capital value are reported on departmental balance sheets.<sup>9</sup>

## 2. Value for Money Issues in Private Financing: is it "a Good Deal for the Public Purse?"<sup>10</sup>

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2.1 Whether the private financing of public assets has produced value for money to the public sector has been an issue of considerable political and academic debate in the UK. The debate has been whether the use of private financing has produced "additionality" in terms of either additional funding for, or the enhanced productivity of, public services. In terms of whether PFI spending has been in addition to or in substitution for traditional public expenditure, certain commentators have suggested that PFI capital spending may be additional to public sector capital expenditure but:

*"in reality it is difficult to demonstrate that something is additional to what would have happened anyway...As a first round effect some PFI capital expenditure is clearly substitutional as some public capital spending is replaced, but it may be additional where second round effects are taken into account: for example, public funds that are*

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<sup>7</sup> Details are derived from HM Treasury, n 3 at paras 2.14-2.18.

<sup>8</sup> HM Treasury, n 3 at paras 2.21-2.25.

<sup>9</sup> HM Treasury, n 3 at para 2.26.

<sup>10</sup> This phrase is adopted from the title of an article by leading academic commentators on the PFI: Ball, Heafey and King, "Private Finance Initiative - A Good Deal for The Public Purse or a Drain on Future Generations?" (Policy and Politics, Vol 29 No. 1: 95-108).

*released from a department's capital programme by an injection of PFI investment are used elsewhere to create additional activity.”<sup>11</sup>*

- 2.2 Rob Ball, Maryanne Heafey & David King, leading academic commentators on the PFI, have suggested at least three ways in which PFI could lead potentially lead to additional public investment: by accessing new sources of finance, by overcoming a structural constraint on public expenditure, or by privately financed projects being materially more economical than public sector ones and thus leading to a higher volume of investment for a given level of funding.<sup>12</sup> The first two entail “additionality” by greater funding capacity, while the last entails “additionality” by enhanced productivity. Each is considered below.

*Additionality: New Sources of Financing?*

- 2.3 At an early stage of the development of the PFI it was implied that the PFI could allow additional investment above that possible if public finances alone had been used. While some commentators have suggested that PFI can tap sources of finance not normally available to the public sector the prevailing view is that both private and public sectors tap the same financial markets and therefore any additionality under this head is illusory:

*“the well developed system of capital markets in the UK with its access to global markets, means that a wide range of funds is available to both government and to private promoters to finance UK based projects. It is possible that private promoters may be able to tap some funds which would not normally be used for gilts.<sup>13</sup> But no measurable differences in macro economic effects are likely to follow.”<sup>14</sup>*

*Additionality: Overcoming constraints on public expenditure?*

- 2.4 A more compelling hypothesis is that private financing allows the public sector to overcome a constraint on public expenditure by the ability to move privately financed public assets off the public sector balance sheet. In the UK the Public Sector Net Cash Requirement (PSNCR, formerly Public Sector Borrowing Requirement (PSBR)) acts as a clear structural constraint on public spending: this is because the UK Government is committed by the Maastricht Treaty to limit PSNCR to 3% of GDP. Traditional public sector investment must be funded up front and as a result has the effect of increasing the PSNCR.<sup>15</sup> While the UK has a clear constraint on public expenditure pursuant to the Maastricht Treaty many economies will have a similar constraint, albeit manifested as a political or macroeconomic one, so the issues in relation to the PSNCR as a structural restraint are of wider relevance.

- 2.5 The foundation of the additionality argument under this head is that, provided an appropriate level of risk is transferred, a privately financed project will not appear on the public sector's balance sheet and will not immediately count against PSNCR, even though “the value of the financial commitment by the government may be very similar whether the public sector owns the asset or not”.<sup>16</sup> However, as capital on a PFI project is repaid it counts against PSNCR,

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<sup>11</sup> Allen, “The Private Finance Initiative (PFI)”, House of Commons Library Research Paper 03/79, 21 October 2003.

<sup>12</sup> Ball, Heafey and King, n 4.

<sup>13</sup> A Gilt is a government guaranteed bond issued through the United Kingdom Treasury, the prevailing 90 day rate for which is said to represent the “risk free” rate of return.

<sup>14</sup> HM Treasury, Supplementary Answers from HM Treasury from the Committee on Private Finance for Public Projects in Treasury and Civil Service Committee, “Private Finance for Public Projects: Minute of Evidence”, 17 February 1993, HC, cited in Ball, Heafey and King, n 10.

<sup>15</sup> Ball, Heafey and King, n 10 at 98.

<sup>16</sup> Ball, Heafey and King, n 10 at 98.

unlike conventional public sector projects where the effect on the PSNCR occurs immediately the investment is undertaken.<sup>17</sup> Heafey, Ball and King succinctly state the potential scope for private financing to overcome structural spending constraints in the following terms:

*“Traditional public sector investment must be funded quite upfront and as a result has the effect of increasing the [PSNCR]. With PFI, since the asset is funded and owned by the private sector, it appears that the investment can be provided without affecting the [PSNCR], even though the present value of the financial commitment by the government may be very similar. . . Thus with PFI, providing that an appropriate level of risk is transferred, the project will not appear on the public sectors balance sheet and will not immediately count against the [PSNCR]. . . However, as the capital and the PFI project is repaid it does count against [PSNCR] (unlike conventional public sector projects, where the “hit” on the [PSNCR] occurs immediately the investment is undertaken). Thus it is highly likely that the use of PFI will tend to defer the effect on [PSNCR], placing the financial burden onto future generations.”*

2.6 Two points should be noted in relation to this analysis. In terms of concerns regarding intergenerational equity, it could be suggested that spreading the costs of an asset over the whole of its economic life is a fairer means of procuring assets than bearing the consequences of such procurement upfront when the asset is first procured. Secondly, it is implicit in the Heafey, Ball and King analysis that in the short term private financing can overcome PSNCR (or equivalent) restraints, as long as the project is “off balance sheet” for the public sector. However even this advantage is subject to further limitation in terms of the actual scope of public sector balance sheet treatment, and therefore it is necessary to look at practical issues relating to balance sheet treatment to determine the extent to which these constraints may be overcome.

2.7 The balance sheet treatment of privately financed public assets has been a contentious issue in the UK.<sup>18</sup> The UK government is committed by Government Resources and Accounts Act 2000 to follow generally accepted accounting practice (GAAP) in the UK adapted as necessary for the public sector. The accounting standard most applicable to PFI is the Accounting Standard Board’s (ASB) “Financial Reporting Standard 5 - Reporting the Substance of Transactions” (FRS5). To remove uncertainties surrounding the accounting treatment of PFI transactions in light of FRS5 the ASB published in 1998 an application note (AN) for FRS5,<sup>19</sup> and central to a project’s accounting treatment under FRS5 and its AN are the following principles:

*“Accounting treatment draws a distinction between property - which may be booked as an asset - and services, which are accounted for as current expenditure. It is not generally accepted practice to account for future service payments under a contract as an asset by, for example, capitalising their present value. The issue of importance when accounting for PFI projects, therefore, is whether, on balance, to regard the resulting property as an asset of the government or to report the stream of unitary charge payments as expenditure in the year in which they occur...Where a property has been built through conventional procurement methods the public sector is almost always considered to bear the risks of ownership and the capital invested in that property is booked as an asset in the government’s accounts. Future maintenance and other service charges associated with the property are not booked but expensed*

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<sup>17</sup> Ball, Heafey and King, n 10 at 98.

<sup>18</sup> The consequential effect of private financing removing projects assets and debt from the public sector balance sheet has led to accusations that Gordon Brown is acting as an Enron rather than an Iron Chancellor: see Foot, "P F Eye: An Idiots Guide to the Private Finance Initiative", Private Eye, Issue 1102 (19 March - 1st April 2004).

<sup>19</sup> Accounting Standards Board, “Amendment to FRS5 – Reporting the Substance of Transactions: Private Finance Initiative and Similar Contracts”, 10 September 1998.

*in year cost is incurred. If, as a result of transfer of risks, the government does not enjoy potential rewards accruing from ownership (not merely use) of property, nor the risk associated with owning the property (for example, risk attached to the anticipated value of the property at the end of the contract term) then it would be inaccurate for the government to book that property as an asset.”<sup>20</sup>*

- 2.8 For those contracts that fall within FRS5, whether a party has an asset of the property will depend on whether it has access to the benefits of the property and exposure to the associated risks. This will be reflected in the extent to which each party bears the potential variations in the property profits (or losses) and there are a number of qualitative indicators to be considered when forming a view on the accounting treatment of a project.<sup>21</sup> For instance, on termination for private sector default, if there is no guarantee that the bank financing will be fully paid out by the public sector, this is an indication that the property is an asset of the private sector. On the other hand, where the private sector has significant discretion over how to fulfil the PFI contract and make the key decisions on which the property is built and how it is operated, and therefore on the consequent costs and risks, this indicates that the property is a private sector asset. Where it is concluded that the public sector has an asset of the property and a liability to pay for it:

*“these should be recorded in its balance sheet. The initial amount recorded for each should be the deferred value of the property. Consequently, the asset should be depreciated over its useful economic life and the liability should be reduced as payment for the property is made. In addition, an imputed finance charge in the liability should be recorded in subsequent years using a property specific rate... The remainder of the PFI payment (i.e. the full payment, less the capital repayment and the imputed financing charge) should be recorded as an operating cost.”<sup>22</sup>*

- 2.9 The UK Government’s publicly stated view is that the accounting treatment of the PFI project, and its reflection or otherwise as an asset in the national accounts, is “subsequent and irrelevant to the decision whether to use [private finance]”, and it notes that in fact 57% of PFI projects by capital value are reported on departmental balance sheets.<sup>23</sup> Accordingly even though private financing provides an opportunity to transfer assets off the public balance sheet, such treatment will depend on the allocation of a particular subset of (property related) risks within a project. If UK experience is a guide, a substantial portion of privately funded projects will in any event be retained on the public sector balance sheet.<sup>24</sup>

*Additionality: Increased Productivity?*

- 2.10 This hypothesis is that privately financed projects are a more efficient means of procuring public assets for a given level of public resources, so that more public services can be delivered for a given level of public funding. Issues relevant to this head of additionality are

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<sup>20</sup> HM Treasury, n 3 at paras B20-B23.

<sup>21</sup> HM Treasury, “How to Account for PFI Transactions (Technical Note No. 1)”, para 4.11.

<sup>22</sup> Accounting Standards Board, n 19 at para F51.

<sup>23</sup> HM Treasury, n 3 at paras 2.21 and 2.26 respectively. This has not been the view taken by political opponents of private financing: see the sources cited in Foot, n 18 at 1.

<sup>24</sup> It is not clear whether there would be any material distinction in the application of accounting practice in New Zealand from that developed in the UK. New Zealand law already requires that financial reporting by the Crown, Crown departments and Crown entities be in accordance with GAAP: see ss 27, 34A and 41 of the Public Finance Act 1989. The Accounting Standards Review Board announced on 19 December 2002 that New Zealand entities should be required to adopt international standards for reporting periods commencing 1 January 2007, with the option to adopt for reporting periods commencing 1 January 2005. The Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand is currently considering a new set of Financial Reporting Standards for New Zealand, using the IFRS as a starting point. It is expected that the adoption of IFRS will have ramifications at least for local government accounting.

an understanding of the private and public sectors' cost of finance, and the nature and robustness of risk transfer and risk pricing.

#### Private vs. Public Cost of Finance

2.11 When considering the relative values of the private and public cost of finance it is important to keep in mind the distinction between a corporate and project risk premium and thus the corporate and project cost of capital. If one was to look at corporate risk premiums, it is generally accepted that public funding by central government via taxation carries a lesser funding premium than comparable private funding. Government borrowing is backed by tax revenues, and is perceived as virtually risk free and hence carries a lower funding premium. Determining what is the equivalent private sector cost of funds is more problematic and the difference in the yields of bids issued by public and private organisations respectively have often been used as proxies. By way of a UK example, in October 2003 the yield on government bonds was 4.5%, with similar dated corporate bonds ranging between 5.2% for and 4.9%, suggesting that the extra borrowing cost for corporate bonds could be at least one-half percentage point above government bonds.<sup>25</sup> This is not to say all arms of government carry this level of premium discount over private sector: local government and individual government agencies may not, depending on market perception of credit risk.

2.12 The project risk premium by contrast will be explicitly represented in both bank and equity margins, and represent an additional risk premium which does not explicitly attach to public funding. However this does not mean that public sector funding has a real structural discount over the private sector in terms of project risk. David Carrie of the London Business School has succinctly challenged the proposition that private sector borrowing costs are therefore higher:

*"...in the private sector, investors carry the risk of default and are rewarded accordingly but in the public sector, taxpayers carry the risk but receive no commensurate reward. In other words, although the public sector can borrow at the risk free rate to finance investment, this imposes a residual risk on taxpayers in much the same way as private sector investors but without a reward. Clearly the contingent liability being imposed on taxpayers is a cost that ought to be accounted for in any cost benefit analysis. Unfortunately it is not normal practice to quantify in the public balance sheet these contingent liabilities faced by the public. Once taken into account, the true cost of borrowing is the same for the public and private sector as the underlying risk of a project is the same."<sup>26</sup>*

2.13 It should therefore be recognised that to obtain the benefits of private finance there is an associated risk premium compared to the gilt rate both in relation to corporate and project risk. Private sector finance premiums are accordingly a corporate premium (as in the example above, hypothesised at 50 basis points (bps), i.e. 0.5%, above the risk free rate) and a project premium (typically 70 to 150 bps for lenders) for assuming, allocating and managing the risks inherent in a project.<sup>27</sup> Gilt financing does not carry this risk premium, but the risks in conventional procurement are instead paid for in full by the residual risk holders in the public sector (i.e. taxpayers) if and when construction runs over budget or projects are delayed.

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<sup>25</sup> This analysis is based on that of Cleal and Porter, "PFI Financing Comes of Age", PublicPrivateFinance.com, 10 December 2003.

<sup>26</sup> Cited in Allen, n 11 at 39.

<sup>27</sup> It should be noted that the overall private sector cost of finance is a blend of the lender and equity rates, representing a weighted average cost of capital.

- 2.14 If both the private and public sectors assess and price project risk in the same manner, the weighted average cost of capital of the private sector will carry a premium over the equivalent public sector price. But such a premium will reflect the difference in their respective corporate premiums and not a difference in the underlying project risk. Payment of this premium will represent good value in a privately financed project if the private sector's assessment of its ability to manage project risk results in an overall project cost that is less than the public sector's estimate of its cost of managing those risks, even in circumstances where that the public sector may carry an inherent pricing advantage in terms of its corporate risk. That is to say:

*"Private finance may represent an additional cost, but it not such a significant cost that value for money is inherently likely to be imperilled. The value for money case for [private financing] rests upon the service provider being able to deliver greater costs savings than the increased financing costs in relation to the remaining...total project cost."<sup>28</sup>*

#### Risk Transfer and Risk Pricing

- 2.15 Value for money under private financing is achieved through the transfer of risk to the private sector which is perceived to have an advantage in handling risk, and it is an essential condition of private financing that sufficient financial risk is transferred to the private sector to secure value for money. Key to the determination of the value for money or otherwise of a privately financed as opposed to conventionally funded project is the use of a Public Sector Comparator (PSC). A PSC is a hypothetical risk-adjusted costing by the public sector, as supplier, to an output specification produced as a part of a procurement process. It is expressed in net present value terms, based on the recent actual public sector method of providing that defined output and takes account of the risks which would be encountered by that style of procurement.<sup>29</sup> To be a valid benchmark against which public sector bids can be compared fairly, the PSC must reflect not only certain procurement costs but also the additional risk that costs may arise which under private financing will fall to the private sector. The purpose of the PSC is to provide a benchmark against which to form a judgment on the value of money of privately financed bids.

- 2.16 There have been a number of studies into value for money issues and private financing:

- (a) The National Audit Office in the UK has undertaken a number of analyses of privately financed projects and assessed the value for money determination in the context of the PSC. Seven of those projects were judged for value for money purposes against a PSC, with the total net present value of the PSC of the seven projects being approximately £4.6 billion compared to the present value of the winning bid of just over £3.7 billion. This suggests that total cost savings of these projects was 20% or just under £1 billion, although 2 of those projects accounted for almost 81% of total saving. If the National Audit Office sample excluded those projects then estimated savings would be 10%, or £500 million.<sup>30</sup>
- (b) A report commissioned by the Treasury Taskforce found that among a sample of 29 PFI projects for which a PSC was available the average saving was closer to 17%.<sup>31</sup>

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<sup>28</sup> Arthur Andersen/Enterprise LSE, "Value for Money Drivers in the Private Finance Initiative", 17 January 2000, para 3.10.

<sup>29</sup> HM Treasury, n 2 at para 2.3.

<sup>30</sup> See Arthur Andersen/Enterprise LSE, n 28 at paras 3.50-3.56.

<sup>31</sup> Arthur Andersen/Enterprise LSE, n 28.

- (c) Looking at matters other than the PSC, the National Audit Office studies have also confirmed that private financing has produced other improvements in public procurement. A National Audit Office review of construction procurement under the PFI<sup>32</sup> concluded that:
  - (i) the majority of English PFI central government projects involving construction have been delivered on time and at the agreed price to the public sector, with greater price certainty for the public sector through private financing than had historically been achieved with traditionally procured projects;
  - (ii) in only 6 of the projects surveyed had there been an increase in the annual payments of more than £10,000;
  - (iii) where there had been a construction related price increase it was mainly due to changes initiated by departments or other parties, rather than the private sector;
  - (iv) where privately financed projects have been delivered late departments have been able to defer payments or seek financial damages; and
  - (v) there was clear evidence of risk transfer to the private sector and such transfer had in certain cases resulted in the private sector incurring losses in particular projects.

2.17 It is important however to note the limitations on these and other analyses.

- (a) The 2001 National Audit Office report on PFI construction performance did not explicitly consider whether there was an appropriate balance between the rewards the private sectors are earning and the risks they are bearing in privately financed projects, privately financing was the best procurement route for the projects in question and nor how well the construction element would have been performed had these contracts been let using more traditional procurement methods but adopted improved forms of working from the construction industry.
- (b) The possibility of other forms of procurement delivering similar benefits to private financing has been referred to by other commentators. For example, others have commented that:
 

*“There is no [logical] reason why public procurement should not run to time and cost. Indeed many of the assumed benefits of PFI would appear to be available to better managed and controlled conventional procurement”.*<sup>33</sup>
- (c) Scepticism has been expressed by some about the robustness of the PSC analysis in considering value for money. Ball, King, and Heafey<sup>34</sup> have argued in response to the 17% savings figure suggested by the Arthur Andersen/Enterprise LSE report of January 2000 that:
  - (i) sufficient data to evaluate risk transfer was only available in 17 of the projects considered;

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<sup>32</sup> National Audit Office, n 1.

<sup>33</sup> Treasury Committee, “The Private Finance Initiative”, Supplementary Memorandum from TUC, HC 147 1999/2000, cited in Allen, n 11 at 27.

<sup>34</sup> “Risk Transfer and Value for Money in PFI Projects”, Sixth International Research Symposium on Public Management, 2003.

- (ii) in these 17 projects achieving value for money was entirely dependent on risk transfer in six cases;
- (iii) in three of these six cases a 20% reduction in risk transfer valuation would have led to a different decision about whether the private financing option offered better value for money;
- (iv) risk transfer accounted for 60% of the total cost saving for the projects; and
- (v) the analysis is dominated by 2 large projects who provide 82% of the cost saving and who have “suspiciously large” cost savings (24.5% and 59% respectively).

2.18 A further feature of a PSC analysis is that the PSC is focussed only on narrow benefits and costs of future project options, often done at stage where it is not possible to take sufficient account of wider factors around pursuing a PFI procurement programme. Recent National Audit Office reports have emphasised that the financial appraisal inherent in the preparation of a PSC is just one part of overall assessment of a project’s value for money, and that value for money decisions should not be based on one dimensional comparisons of a single “bottom line” figure. In particular, in the context of its report on the Middlesex Hospital PFI, the National Audit Office considered that:

*“approval processes should not, explicitly or implicitly, place undue emphasis on the need for projects to demonstrate savings, however small, against a PSC in order to gain approval. The emphasis should be on demonstrating value for money taking all benefits and disbenefits of the PFI approach into account. There is a risk that project teams may devote too much time refining [sic] their financial comparison calculations, at the expense of a more rounded and valuable assessment. Financial and wider non-financial should be considered in deciding whether to go ahead with a PFI procurement”,<sup>35</sup>*

and further:

*“The attention given by the Trust to the figures shown by the financial comparison may have masked evidence of important wider benefits that the PFI approach was expected to secure.”<sup>36</sup>*

2.19 As with accounting treatment issues, the content and value of the PSC analysis is not an issue that is free from controversy. The essential criticisms that commentators such as Ball, King, and Heafey have made are that achieving value for money often depends on risk transfer and that risk valuation depends on a range of subjective judgements.<sup>37</sup> Perhaps a more fundamental issue to note is that while the current assessments do establish that the use of private financing has produced additionality by increasing the efficiency of public service delivery it is explicitly conceded that:

*“the operational benefits of PFI will take much more time to establish [and] the long-term value for money of PFI projects will depend on how well the private sector*

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<sup>35</sup> National Audit Office, “The Middlesex Hospital PFI”, 21 November 2002, HC 49 2002-2003, at para 14 E.

<sup>36</sup> National Audit Office, n 35 at para 13.

<sup>37</sup> The appropriateness of judgments regarding the intangible benefits of the a privately financed proposal which may enhance its value for money has however been explicitly affirmed by the National Audit Office.

*manages the risks transferred to it and on public sector success in managing the contracts over the duration, a significant proportion of which are for 25-30 years.*<sup>38</sup>

#### *Enhancing the Value for Money of Privately Finance Projects*

- 2.20 The current status of the UK PFI market has highlighted certain practical impediments to the future development of private financing.
- 2.21 Firstly, the terms of private financing in the UK are said to have “reached a plateau of maximum efficiency”.<sup>39</sup> Inter-bank competition, and bank versus bond market competition, has led to improvement in most lending parameters to the point where projects are struggling to achieve an investment grade rating and there is pressure from lenders to claw back some of these concessions. Competition between funding providers cannot be relied on to provide further improvements in the terms of private finance.
- 2.22 Secondly, high bid costs are an impediment to bidding, particularly for low capital value schemes. It is thought that the total cost of tendering for privately financed contracts to all potential contractors is just under 3% of expected total costs, while for traditional procurement the total costs account for just under 1%. Furthermore all privately financed projects face the cost of using third party finance and small schemes typically face the same level of legal and technical documentation, due diligence and financial modelling that lenders require for much larger projects. These costs do not necessarily fall in proportion to the size of the project and the costs of private finance are therefore disproportionately large for smaller schemes.
- 2.23 Thirdly, it has become apparent that certain areas do not fit the private finance model, a key example is IT procurement. This is for a number of reasons. The fast pace of change it makes it difficult for the public sector to effectively define the outputs it requires in the long-term contract, while the duration and phasing of investment ( IT projects have a short life and includes significant asset refresh) means defining and enforcing long-term service needs is problematic.
- 2.24 Solutions are currently being pursued in the UK in relation to certain of these issues. To address the relatively high level of transaction costs for smaller projects there is now a general presumption against private finance being used for smaller schemes: while minimum values of projects will vary from sector to sector, experience to date suggests that this value is likely to be around £20 million. For schemes below this level the "bundling" of smaller projects is being considered as a means of creating a sufficient critical mass for private financing. Emphasis has also been placed on the standardisation of project documents to further reduce transaction costs.
- 2.25 Consideration is also being given to removing the private sector (corporate) funding premium from project funding costs by the use of credit guarantee finance. Under credit guarantee finance the government would lend to the project the sums needed to finance the senior debt portion of the overall financing package, provided the private sector was able to offer credit guarantees for repayment of that loan. Therefore the private sector would still engage financial partners, but these financiers would provide guarantees to the public sector to repay principal and interest as and when it falls due rather than advancing cash to the borrower. Therefore the government would be lending funds to the private sector contractor with the benefit of a guarantee from the credit providers. If there was a default by the contractor the credit providers would fully repay the government loans. The public sector's credit risk is the

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<sup>38</sup> Arthur Andersen/Enterprise LSE, n 28 at para 2.1.

<sup>39</sup> See generally Cleal and Porter, n 25.

creditworthiness of the credit guarantee provider rather than the credit risk of the project itself. This use of credit guarantees is an extension of the monoline insurance<sup>40</sup> products already extensively used in the UK market. These products “wrap” a project’s credit risk with the investment grade balance sheet of the monoline insurer and thereby enhance the credit status of a project, with the public sector lender (rather than a private sector one) being the beneficiary of the guarantee.

### 3. Practical and Policy Issues for New Zealand

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*Is private financing a cure for a peculiarly British disease?*

3.1 It is suggested there is no evidence that NZ is immune from deficiencies in public procurement. Relevant examples include:

- (a) The \$107 million Police computer project (INCIS) was halted in October 1999 when IBM abandoned the project, two years over deadline and \$20 million over budget. Only the first of INCIS’s 3 plan stages was in place at that time. Under the INCIS project the department brought 2000 personal computers, 1084 laptops, 452 printers, 400 servers, a mainframe and networks. Both Audit Office and governmental inquiries were subsequently held into the circumstances of the INCIS failure. The main hardware elements of the project were later sold by the government, and at the time police resources were placed under considerable strain by the financial consequences of the INCIS failure. Claims between the government and IBM were eventually settled by IBM paying \$25 million in settlement and withdrawing its \$75 million counterclaim against the government, with the government paying IBM \$18 million in final payment for work completed and equipment delivered.
- (b) The HMNZS Charles Upham was purchased as a logistics vessel for the New Zealand Navy at a cost \$14 million with another \$7 million being spent on modifications. It was withdrawn from service in August 1996 due to its propensity to roll dangerously even in moderate seas unless carrying a substantial load: in fact, the ship rolled so much that it earned the nickname the “Chuck Upham”. It needed ballast tanks and a larger keel to stop it rolling dangerously, plus extra accommodation, a deck crane, improved water tightness and helicopter support facilities. In May 1999 it was announced that remedial works would be undertaken and in the meantime the ship had been used on charter as a fruit carrier in the Mediterranean. The Upham was subsequently sold for \$8.6 million.

The examples above are not used to suggest that private financing would be an answer to the specific procurement problems identified in those projects, but rather as an illustration that New Zealand is subject to the same public procurement problems that affect other governments.

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<sup>40</sup> The insurance is said to be “monoline” because this type of credit insurance is the only line of insurance carried by the insurer.

*Is private finance a fundamental or incidental element in improving public sector procurement?*

3.2 The issue here is what role private finance has played in improving public procurement, and whether private finance could be said to be a fundamental or incidental element in that improvement. Certain commentators have suggest that there is no reason why new forms of conventionally funded public procurement could not deliver the benefits delivered by private financing. Such new procurement methods could:

- (a) incorporate the use of “output” based service specifications;
- (b) have a similar risk allocation in terms of delay and performance;
- (c) provide for private sector equity investment but with the public sector conventionally funding the greater proportion of project capital by an upfront contribution (“subvention”);
- (d) allow an extended contract period in order to promote whole life asset costing; and
- (e) sculpt project revenues to produce a project “tail” in order to incentivise private sector performance over the whole of the contract period.

3.3 Certain elements of this view are reflected in the recent Auckland Indoor Stadium project and the proposed use of "Infrastructure Bonds"<sup>41</sup> as a means of funding infrastructure development. The scheme for the latter bonds is not currently clear, with suggestions such bonds would be issued to the public or that migrant investors' capital could be held as a bond. The proceeds from the bonds would then be “on-lent” to finance infrastructure investment enabling a “closer linkage between raising the finance and the application of the funds.”<sup>42</sup> It is not currently clear how this “close link” is to be made.

3.4 There is little question that the use of private sector equity linked with public sector subvention payments would provide an enhanced incentive for private sector delivery, but the key question is whether it uses limited government funding resources in a manner which creates the greatest incentive to meet the public sector's policy objectives. That is to say, the question is not whether it is an effective incentive but whether it is the most effective incentive. The use of large public sector subvention payments in conjunction with private sector equity investment has a number of relative deficiencies when compared with private sector debt provision.

- (a) A key deficiency with reliance on subvention payments, and with the related of infrastructure bonds to fund those subvention payments, is the removal of lenders as third party due diligence providers. The interest of a lender in a project is quite different from that of equity in that lenders will not share in project “upside” risk. The best that can happen is that the lender gets its money back. Accordingly lender due diligence plays a key role in mitigating the optimism bias that can affect both public sector and private sector risk assessments. A useful example is a recent Standard & Poors study into optimism bias in roads which found that optimism bias is a consistent trend in toll road traffic forecasting.<sup>43</sup> Of the 32 case studies analysed by Standard & Poors 28 forecasts over estimated traffic, only four of the case study forecasts under estimated traffic and it is noteworthy that half of the underestimates related to

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<sup>41</sup> See the Infrastructure Stocktake Report Back, Cabinet Paper, 17 May 2004.

<sup>42</sup> Infrastructure Stocktake Report Back, n 41.

<sup>43</sup> Standard & Poors, “Credit Implications Of Traffic Risk In Start–Up Toll Facilities”, October 2002.

forecasts prepared for shadow toll roads which are perceived to have less traffic risk than actual toll projects. More importantly, it was found that the lenders' average error (18%) was nearly half that recorded for the other parties (34%), and lender forecasts consistently appeared to be less prone to large error than those commissioned by sponsors. While roads and other sectors in which user or usage payments<sup>44</sup> determine the project revenue stream do accommodate upside assessments (an increase in volumes may lead to a disproportionately larger increase in shareholder returns) it is suggested the nature of the problem is no different even if a project is based on an availability based payment model, albeit the scale of project upside and thus of optimism bias may be of a lesser degree.

- (b) If the public sector funding obligation (whether pursuant to infrastructure bonds or otherwise) is recognised as a government liability this would seem to foreclose the public sector using private financing to overcome structural funding constraints even on the limited basis noted above in the context of the additionality discussions. There seems little benefit in obtaining off balance sheet treatment for a public asset when the government's funding obligation in relation to that asset is in any event recognised. Additionally with bonds (such as the proposed Infrastructure Bonds) what is being priced is public sector corporate (i.e. balance sheet) risk, and therefore the public sector is less likely to get less transparency of risk pricing than if it was project risk itself being priced. This remains subject to clarification of how the "linkage" between the bonds and particular projects is to be manifested.
- (c) The consequence of the public sector performing the role of the principal capital provider for a project is that public sector remains the residual risk holder in that project. This is true both in the sense of operational risk as well as termination risk. In relation to operational risk, the public sector cannot rely on third party lenders to manage project risk (by step in or other measures in relation to management of the contractor or subcontracts) and this role must be performed by the public sector. The issue in relation to termination compensation is discussed in more detail below.
- (d) Profit sharing mechanisms have also been used to gain a return on publicly funded project capital in projects funded by public sector subvention payment. It is suggested however this may create perverse incentives to the private sector in relation to risk management and may weaken the underlying transfer of risk to the private sector under the contract. In a private financing scenario changes in project costs (e.g., operational costs such as insurance, or finance costs such as increases in interest rates) will have a direct impact on equity return. A central element of the project risk structure is that the private sector is exposed to costs changes and is therefore incentivised to efficiently manage those costs and maintain its rate of return. That is to say, equity has the residual entitlement to project value and ranks after project and funding costs (here, senior bank debt). However in a public sector subvention scenario (such as the Auckland Indoor Stadium) projects costs and shareholder returns rank before the capital provider (here, Auckland City). There is therefore less incentive for the provider to efficiently manage project costs as any increase in those costs will go to reduce the benefit to that party entitled to the residue of project value, which in this case is the public sector rather than shareholders. The incentive for shareholders to efficiently manage project risk is enhanced if the provider is entitled to share with the public sector in any profit in excess of a threshold level (which again appears to be the scheme applicable to the Auckland Indoor Stadium), but this remains a weaker incentive for efficiency than if changes in (for example) operating costs were to directly and exclusively diminish shareholder value.

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<sup>44</sup> User payment are charges are levied directly on users, while usage payment are payments made by the public sector on the basis of actual volumes. The latter generally has payment bands to enhance a project's bankability at lower volumes and to cap the public sector's financial liability at higher volumes.

### *Policy Challenges: Refinancing Gain and Termination Liabilities*

- 3.5 The fact that a project is privately financed creates risk and reward opportunities for both the private and public sectors. The successful management of project risk may enhance the private sector's rate of return, while changes in the financing structure may lead to an increased (contingent) public sector liability for termination payments payable to private sector financiers. Therefore a new policy issue for privately financed procurement, as contrasted with conventionally funded procurement, is the appropriate balance of risk and reward in relation to refinancings. This issue is relevant whether the refinancing is voluntarily undertaken in order to enhance project returns, or in a scenario where the project is in distress.
- 3.6 Refinancing gain arises when shareholders in a privately financed project enhance their rate of return by refinancing a project's debt (which is generally between 85 and 90% of total project funding) on more favourable terms. The UK experience, and particularly the circumstances of the Fazakerly prison refinancing,<sup>45</sup> offers a clear lesson in the political risk to value for money perceptions if refinancing issues are not squarely addressed at the outset of a private financing programme. The circumstances of the Fazakerly refinancing (a gradual market and sector reduction in senior debt risk premiums over time, the enhanced effectiveness of financial instruments such as hedging), and the development of new project instruments such as bond financing, will all create refinancing opportunities for early projects in an emerging private finance market. The more difficult lesson to be learnt from the UK experience is what particular regime should be adopted in an emerging market in relation to the sharing of refinancing gain. The UK model of 50/50 sharing between the public and private sector is now largely an agreed one for the maturing UK market, at least insofar as it relates to the calculation and sharing of refinancing gain, but that is not to say it is automatically appropriate for an emerging market. In such a market the public sector faces a policy dilemma: how to stimulate the private finance market while not allowing unacceptable "windfall" gains to accrue to the private sector.
- 3.7 Refinancing is also relevant to the calculation of termination liabilities on termination for other than private sector default, as in these circumstances the public sector will be required to repay the outstanding senior debt. Further advances or other relief to the project company during the contract period, either as part of a rescue package or in order to produce refinancing gain for shareholders, may increase the public sector's contingent termination liability. The public sector will therefore be reluctant to allow unrestricted dealings that may increase this contingent termination liability, while lenders will be reluctant to rescue a project unless there is some comfort that additional advances will be repaid on a subsequent termination where the private sector is not in default. The development of an acceptable commercial outcome to this policy dilemma has been a central issue of debate in the UK, and it is yet to be seen whether the latest UK guidance will be generally accepted in the UK market.<sup>46</sup>

### *Policy Challenges: Termination Compensation on a Private Sector Default*

- 3.8 In a privately financed project a private sector default will lead to a compensation assessment, as otherwise the public sector will receive a windfall benefit of the capital investment already made in the asset which the public sector takes over on a termination.<sup>47</sup>

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<sup>45</sup> For a discussion of the Fazakerly refinancing and the development of UK policy on refinancing generally see Lonergan, "The Refinancing of Public Private Partnerships: UK Lessons for Emerging Markets", (2004) 15 *Journal of Banking and Finance Law and Practice*.

<sup>46</sup> HM Treasury, "Standardisation of PFI Contracts - Version 3", 3 April 2004, 253-274. For a discussion of the development of UK policy on termination liabilities in the context of a refinancing see Lonergan, n 45.

<sup>47</sup> There are however certain market sectors where this is not necessarily the case (such as roads).

If however the public sector is obliged to pay out all of the outstanding senior debt on such a termination this substantially diminishes the incentive to efficiently price project risk: what is being priced is public sector balance sheet risk rather than project risk. Therefore a different compensation model is required which allows both the shareholders and lenders (and not the public sector) to bear the loss of value arising from a termination. This loss of value could be in the form of the cost of remedial undertakings (to get the project to the point where it is capable of performing to the required standard) or in increased public sector payments to a replacement provider (to reflect that the initial provider had underpriced the contract). In private financing this loss of value is to be borne by the private sector and (subject to certain conditions being met) will not require the public sector itself to make any compensation payment. In conventional procurement this loss of value will be borne by the public sector, although the public sector may reserve rights of recovery against the private sector. These different scenarios are outlined below.

- 3.9 Following the termination of a privately financed project there will be an assessment of the residual value of the contract (essentially the current value of its future revenues) and a mechanism to ensure that that any loss of value will be borne by the private sector. That value is derived by determining (either by actual sale or by valuation) what a third party would pay as a lump sum to take over the contract on the basis of its current revenue stream. If the existing revenue stream is not sufficient to allow that new provider to perform in accordance with the contract (either because of required remedial works or because of the underpricing implicit in that project's revenue stream) then the sum the new provider would be prepared to pay for receiving that revenue stream will be discounted. The extent of that discount represents a loss suffered by the outgoing provider's shareholders and (if the discount is significant) its debt funders. Thus the public sector is shielded from the loss of value in the project in that it continues to get the benefit of the original pricing of the services, and this is what it pays to the new provider. If the value of the residual contract revenue stream is determined by a third party bidding to take over the contract by payment of a lump sum, this also means that the public sector will not itself be required to fund the compensation payment: that will be funded by the incoming contractor and paid via the public sector to the outgoing contractor. If the residual value is determined by a third party valuation the public sector will however need to fund that compensation payment.<sup>48</sup>
- 3.10 This can be contrasted with the termination scenario under a conventional procurement contract, or a scenario (such as in the case of the Auckland Indoor Stadium) where the private sector has made an equity contribution but the great majority of project funding has been met by the public sector. If payment is availability based<sup>49</sup> the public sector will need to pay a higher availability payment to reflect either the cost of remedial works or the higher cost of services. If the project is based on user charges, and user numbers do not reach the projected level, then the new private sector provider may need further payments to support project revenues. In either scenario, the public sector bears the loss of value that would under a privately financed project fall on shareholders and lenders. The public sector may under a project funded by a subvention payment look to recover its lost value from the private sector shareholders under a contractual undertaking to pay. However this type of covenant will be resisted if shareholders wish to limit their exposure to the extent of their equity commitment to the project, and the public sector would still need to overcome other hurdles to a recovery against the previous private sector provider (such as insolvency).
- 3.11 There is plainly great advantage to the public sector if a third party, rather than the public sector, funds the compensation payment. The key commercial issue in the UK in relation to compensation for private sector default is defining the circumstances in which the public sector is precluded from seeking third party bids and must take the valuation route. This

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<sup>48</sup> The current UK HM Treasury guidance on this issue is set out in HM Treasury, n 46 at 139-159.

<sup>49</sup> That is to say, the private sector gets paid for the extent to which assets are made available in accordance with the contract requirements.

debate has turned on defining the circumstances in which there is not a “liquid market” for the contract, and therefore a retendering would not be appropriate. If such a model was to be followed in New Zealand there would need to be acceptance by the private sector, and lenders in particular, that the market was sufficiently developed for the liquid market approach to produce fair value. In the absence of a liquid market there are however other valuation models open to the public sector which value the remaining contract revenues in light of any existing level of underperformance by the private sector.<sup>50</sup>

#### *Political Challenges: Establishing the Value for Money of Private Financing*

- 3.12 Key challenges to the use of private financing are objections based on the value for money, or alleged lack of it, obtained by the public sector. These challenges have both a policy and a practical dimension. In policy terms, there are number of bases upon which the ability of private financing to deliver value for money has been attacked, and these have been outlined above. It is suggested that the objection based on the relative private and public sector costs of finance is ill conceived and can be easily met. The more difficult issue is providing transparency in the comparison of the benefits and disbenefits of privately financed and conventionally procured projects respectively. The challenge for government is ensuring any PSC comparison is perceived as robust, and countering allegations that the use of private financing is being pursued for accounting treatment as an end in itself.<sup>51</sup>
- 3.13 The practical question regarding perceptions of value for money however extends beyond the policy issues noted above. The practical dimension of this challenge is for the public sector as a whole to gain sufficient expertise, and more importantly act with one voice, in relation to key value for money issues. These issues particularly include the issues of refinancing gain and assessments of termination compensation on a private sector default.<sup>52</sup> In the absence of a unified public sector approach to private financing there is a real political risk that ad hoc formulations of policy by central or local government will significantly damage perceptions of the value for money of private financing by allowing rates of return disproportionate to the risks that the private sector is assuming, or otherwise failing to secure for the public sector benefits that it might reasonably be expected to receive.

## **4. Conclusion**

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- 4.1 The debate on the use of private financing in New Zealand to assist in overcoming New Zealand’s infrastructure deficit has in large part centred on additionality in the sense of allowing access to new sources of finance, and overcoming structural constraints (albeit political and macroeconomic ones), to allow a higher level of investment in public assets. The debate has therefore focused on “funding gaps” and the need to “bridge those gaps”. The implication from this debate is that if a project can be funded by conventional means then this will be the case, and private financing will only be used where projects cannot be funded by conventional means. Private finance is seen currently therefore as an answer to a financing problem.

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<sup>50</sup> See Lonergan, “Banking Construction Risk In The London Underground Public Private Partnership: A Case Study in Applied Project Financing”, *International Construction Law Review* [2004] 385 for a further variation on this approach taken in the London Underground PPP.

<sup>51</sup> Allegations of this nature are already being raised: see Newberry, “Taxpayers Put at Risk by Hidden Debt”, *New Zealand Herald*, 6 September 2004, A15.

<sup>52</sup> The National Audit Office report into developments on refinancing issues specifically notes that refinancing is one of several areas where a collective approach by the public sector to negotiations with the private sector has been beneficial: National Audit Office, “PFI Refinancing Update”, 7 November 2002, HC 1288 2001-2002, para 17(a).

- 4.2 It is suggested that this is an unduly limited view of the benefits that private financing structures can bring. While private financing can bring clear benefits in terms of overcoming structural constraints, private financing is now squarely seen in the UK as enhancing the efficiency of public investment: that is to say, private financing is seen primarily as an answer to an agency rather than a financing problem. If one accepts the hypothesis that the use of private finance, and the incentive mechanism created by the role of equity, is the best way to produce private sector actions consistent with policy objectives then the public sector should be considering both the areas which may lend themselves to the use of private finance and the manner in which private finance can be supported in those areas. This may mean moving beyond the limited areas where private finance is currently seen as appropriate (in user or usage charge based models such as roading) to other areas which do not have user or usage charge to support a private financing. These may be public service areas which are and will invariably be public services free at the point of use, but any such consideration must be subject to the practical limits in terms of the scale and nature of privately financed projects already identified by UK experience.
- 4.3 It would be quite wrong to suggest that private financing is a “magic bullet” for public procurement and public services. The principal limitations on the use of private financing are becoming clearly delineated by overseas experience, and the degree of additionality provided by private financing could be said to be incremental rather than revolutionary. It should also be borne in mind that the innovation and whole life costing promoted by private financing will not overcome problems associated with inadequate public services budgets. The use of output specifications assumes that the public sector is capable of defining in clear terms what it wants and expects in terms of public services. It is however suggested that even if private financing can deliver a part of the gains evidenced by overseas experience then its use will be well justified.

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