positively public

PFI:

Against the public interest

Why a 'licence to print money' can also be a recipe for disaster

UNISON

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1. Introduction

The Government's use of the Private Finance Initiative (PFI) and Public Private Partnerships (PPPs) has been marked by two significant failings - the creation of both huge profits and company failures.

Some PFI and PPP contracts have been so badly formulated that private sector contractors are making a fortune, with public bodies and taxpayers being ripped off. "A licence to print money," as transport analyst Christian Wolmar describes the London Underground's massive Public Private Partnerships.

Yet, there is also a growing litany of failed contractors and contracts. Some are failures in the sense that the public sector did not get what it wanted and thought it was paying for through the contract. Others were failures because the company went bust, as was the case with Ballast, may yet be the situation with Jarvis, and was virtually so with Amey, which had to be rescued by a giant Spanish construction company.

These are no 'fly by night' companies, of little significance. Ballast was a major PFI contractor. Jarvis and Amey are partial owners of Tube Lines, holder of one of the two massive but discredited PPP contracts to operate the London Tube. Jarvis may have achieved infamy for its responsibility for the Potters Bar rail crash, but it also deserves notoriety for its failure to properly discharge other contracts on university accommodation and school buildings. Amey has had its own PFI disaster, particularly relating to the Croydon tram project.

The extremes of massive wealth and commercial failure reflects the reality of how the market works. It should be no surprise that this is the outcome of introducing the market into the delivery of public services. The problem is that the public sector loses either way. The huge profits are draining the public sector of money that should be going into public service delivery and improvement. The failures disrupt the provision of essential public services. This is not how it should be.

It has taken the near collapse of Jarvis for the service risks of PFI and PPP to achieve increased public recognition. But it is important that however the Jarvis crisis is resolved, the public policy mistakes and weaknesses that led to this crisis and others are properly addressed - for the first time.

Key points

- **Some PFI/PPP contracts are producing 'mega-profits', generating a new breed of 'fat cats'.**
- **Pressure on other contractors to produce similar profit levels has contributed to the decline and fall of Amey and Jarvis.**
- **The Government loses either way. Fat cat profits come at the expense of the public purse: failed contractors cause disruption to public service delivery.**
- **PFI/PPP contract failures can lead to public bodies having to pay more for service delivery, even though they are not to blame for the contract failures.**
- **Expensive public sector pensions liabilities could boost staff transfers under PFI/PPP contracts, according to former Conservative minister and Jarvis chairman Steve Norris.**
- **Many PFI contracts fail to provide real 'risk transfer' from the public to private sectors.**
- **Transferring debt off the Government's balance sheet comes at a cost of billions of pounds in extra debt charges.**
- **The creation of a 'secondary market' in PFI equity and debt means that the public is unaware who owns 'public assets'.**
- **Some contractors have achieved windfall profits of millions of pounds through refinancing and selling equity stakes in PFI contracts.**
- **A declining pool of willing and able PFI specialists means that the Government will pay an increasingly high price for PFI contracts and will find it difficult to get the market to provide all the schools and hospitals it wants to procure under PFI.**
- **About £200bn in PFI revenue commitments have been entered into by the Government, limiting the spending options of future administrations. Annual expenditure commitments on PFI are at least £4bn until 2012, much more than if these projects were conventionally procured.**

> *"These are not public assets but private sector concessions"*
>
> *David Metter, chairman of the Public Private Partnership Forum and chief executive of Innisfree*

3. State of play

The Private Finance Initiative and Public Private Partnerships have become central to the Government's strategy for public service delivery, investment and reform.

According to the Treasury's figures £40bn of PFI contracts have so far been signed. But this significantly underestimates the importance of the PFI and PPP sector. By adding in PPP contracts the figure is far in excess of £100bn. However, the Treasury figures also apparently only refer to the capital value of projects alone, not the revenue commitments. In 2001 these revenue commitments totalled £100bn – and the capital value of signed PFI schemes has since doubled.

PFI and PPP are attractive to the Government, in part because many of the contracts take debt off the Government's balance sheet. Hiding the true level of debt helps to comply with one of the Treasury's fiscal rules, not borrowing in excess of 40% of GDP, and in conforming to European Union rules on fiscal deficits.

The City benefits directly from the policy through big fees for merchant banks, accountants and lawyers, while creating potentially very large profits for some PLCs.

But, as we shall explore, the policy brings with it serious downsides. By taking debt off balance sheet, the interest paid is raised significantly. Future years' expenditure is already committed to a large degree, limiting the flexibility of future governments in determining expenditure priorities. And by placing responsibility for public service delivery in the hands of the private sector, the Government becomes vulnerable to the vagaries of the market.

This has most vividly been shown in the decline of Jarvis, the once mighty PFI contractor that was responsible for the Potters Bar rail crash. Its dizzying fall is illustrated by a share price that was almost £4 in the middle of 2003, dropping to just 22 pence a year later. Its continued existence as an independent company is now in doubt, forced to negotiate with its banks Royal Bank of Scotland and Barclays. Jarvis has been subject to a steady growth in the minority share holding by the United States fund K Capital, an aggressive purchaser of high risk shares which is now Jarvis's largest shareholder and is perceived by some analysts as maximising its opportunity to take profits from a disposal of the company's underlying assets. (Daily Telegraph, 19th May, 2004) Rescue for Jarvis could come through a purchase either of the company or of its prime assets - its share of PFI and PPP contracts, particularly its stake in the London Underground PPP Tube Lines consortium.

But is it right that both a company's responsibility for future public service delivery and its ownership of public service assets should be sold and bought in this way? What is the likely impact on the general public and the public purse? These are questions which we seek to answer in this paper.

What are the Private Finance Initiative (PFI) and Public Private Partnerships (PPPs)?

The Treasury defines three types of PPP arrangements one of which is PFI.

1. PFI is the mechanism for the public sector to contract for the purchase of services on a long-term basis "to take advantage of private sector management skills incentivised by having private finance at risk". This will commonly involve the private sector supplying a new major capital asset, such as a hospital or a school, on a design, build, finance and operate basis.

2. The introduction of private sector ownership into state-owned businesses. Examples include Strategic Service Delivery Partnerships, typically running local authorities' back office operations, and the two contracts held by Tube Lines and Metrolink for the operation and improvement of the London Underground. Also LIFT (Local Improvement Finance Trust) the model for Primary Care Trusts and Building Schools for the Future – the model for renewing the secondary school stock.

3. The Wider Markets Initiative, under which private sector expertise and finance are used to sell government skills and knowledge into commercial markets.

('PFI: Meeting the investment challenge', published by HM Treasury)

4. The flaws in the argument - Why PFI and PPP don't work as the Government hoped

4.1 Risk

The underlying principle of PFI and PPP is that risk is transferred from the public to private sectors. ("To take advantage of private sector management skills incentivised by having private finance at risk," 'PFI: Meeting the investment challenge', published by HM Treasury.) That risk transfer, theoretically, provides financial certainty for the public sector client and justifies the higher cost of borrowing involved.

But is this principle implemented in practice? UNISON's report 'Public risk for private gain?' illustrated the often illusory nature of risk transfer of PFI and PPP schemes. Failed PFI contracts, on too many occasions, have had to be rescued by the public sector meeting additional costs. Whatever the terms of the contract may say, with essential public services it is the government (or other public body) which remains the guarantor of last resort.

Just one example is the Royal Armouries PFI contract, where the contractor was bailed out by the public sector despite the contract terms. This case was critically reviewed by the National Audit Office and the House of Commons Public Accounts Committee. In other cases - such as NIRS2 (the National Insurance Recording System); National Air Traffic Service (NATS); Passport Agency and the benefit payment card - problems caused by the contractor did not prevent the public body client meeting additional financial liabilities. (These cases have also been reviewed by the NAO and the PAC.)

Risk varies during the life of a PFI contract. The highest risk comes during the construction phase, from cost over-run and late completion. The subsequent service delivery phase has a low risk attached. Contractors have learnt that they can obtain large profits by exploiting this change in risk profile.

This point was spelt out in a report from leading credit ratings agency Standard & Poor's ('PFI projects reshape the credit profile of Europe's construction companies') which concluded that in the initial phase of a major PFI construction project, the primary contractor was exposed to high risks. But, the report added, construction companies exposure to risk reduces as the projects mature.

What is debt and equity?

Debt - consists of the loans a company takes on. Debt includes bank loans, overdrafts and bonds - fixed term, fixed interest loans. Holding debt in a company does not give you ownership of it. But if a company hits trouble it is legally required to repay loans before it pays shareholder dividends or buys back shares. Bonds can be traded on the financial markets. The cost of company debt is determined by the credit status of a company as laid down by credit ratings agencies, such as Standard & Poor's.

Equity - in the context of a company - is another word for the shares held in it. The owners of the equity are the owners of the company. Equity can be bought and sold. A PLC - public limited company - has shares which can be owned by the public, usually traded on one of the stock exchanges. Shares in private companies can be traded privately.

What is more, construction companies holding several PFI contracts can improve their credit ratings compared to companies without significant PFI involvement, because of the low risk profile of service delivery phases of these contracts. This is also why PFI investments after the start-up phase are so attractive to pension funds. These factors help to explain the opportunities for refinancing and the sale of equity stakes in companies set up to operate PFI projects.

Great play is made by the Government and contractors of the fact that PFI is much more efficient than traditional procurement in delivering major construction projects on time. However, the point has been made (Sunday Business, 10th June 2002) that while the private sector absorbs typical cost over-runs of 7%, it factors in additional charges of 12.5% to cover this.

4.2 Refinancing

The construction period of a PFI project carries a much higher risk factor than the subsequent service delivery period. Standard & Poor's indicate ('PFI projects', ibid.) that this might typically move a credit rating from BBB rating to AAA.

Standard & Poor's Credit Ratings

The cost of company debt is determined by the credit status of a company as laid down by credit ratings agencies, such as Standard & Poor's

AAA	highest quality
AA	high quality / very strong
A	upper medium grade / strong
BBB	medium grade
BB	somewhat speculative
B	speculative
CCC	highly speculative
CC	most speculative
C	imminent default
D	default

The costs of debt servicing are directly related to credit rating. This explains why PFI is a more expensive means of raising capital than government borrowing - the UK Government is AAA, but in development phase a PFI investment is typically rated BBB.

For a prime contractor to take advantage of the potentially lower cost of borrowing as a PFI contract enters maturity (moving from the establishment phase to the service delivery phase) it must refinance the loan - equivalent to a householder cutting home loan costs by remortgaging when interest rates go down.

From the outset, the Treasury recognised the opportunities for PFI contractors to cut their costs through refinancing as the contract matured. Its position was that this was not a factor of concern to the public sector client, as bidders will have factored this calculation into their tenders. In guidance to public bodies ('How to manage the delivery of long term PFI contracts'), it says merely that procurers' responsibilities include "receiving notification of any proposed refinancing arrangements, considering any implications for the Authority including the potential for sharing any gains between Contractor, financiers and the Authority, and where required, notifying the Contractor of the Authority's conclusions". But this failed to stipulate - as it clearly should in hindsight - that contractors should have a contractual duty to share the benefits achieved by refinancing. Nor did it spell out sufficiently forcefully that public authorities should not disadvantage themselves in assisting refinancing by re-accepting some of the risk in the contract.

The Public Accounts Committee issued a strongly critical report on the refinancing of the Fazakerley prison PFI contract, which enabled contractors Group 4/Carillion to obtain a windfall profit of £10.7m. The Prison Service very unwisely accepted a reverse risk transfer, in return for a rebate of just £1m. In some instances, PFI contract refinancing increased contractors' profits by as much as 80%. ('Refinancing', Unison, 2001).

Subsequently, the Office of Government Commerce issued a report in November 2002 recommending that with old deals - where no agreements were in place - any refinancing windfall profits should be split 70/30, to the benefit of the contractor. But on new deals, contracts should specify a 50/50 division of refinancing profits. While it is now specified that the public sector will gain from refinancing, the rewards for contractors can still be substantial. The refinancing of Octagon Healthcare, the Special Purpose Vehicle (SPV) running the Norfolk and Norwich hospital, achieved a £4.1m profit for Serco - just one of the shareholders in the SPV. (Serco accounts, 2003)

4.3 Secondary market

The secondary market is the mechanism by which initial investors sell their equity stakes and bonds in PFI companies, often to investment funds. Insurers and pension funds, in particular, are interested in taking on equity stakes and debt (including from refinancing) which have low risk, but virtually guaranteed income streams over, perhaps, another 20 to 25 years.

There are benefits of the secondary market to PFI specialist companies. They can provide millions of pounds in windfall profits. But refinancing and the 'secondary market' also attract new sources of funds into the PFI investment market. Without additional investors the ability of contractors to bid for and provide assets and services under PFI arrangements would now be drying-up.

Ernst & Young says: "As funding becomes more difficult to obtain, so the contractors will look to refinance or exit [sell their equity stakes] from their projects in order to reinvest in new PFI deals." (Press release, 8th September 2003) Its report 'PFI grows up' explains: "The Ernst & Young survey shows that contractors believe attracting funding for PFI projects will become harder during the next two years [2004/5]. A number of funders have recently withdrawn from the market. Banks are concentrating on deals worth £50m, while insurers are looking at £100m plus projects, the survey says." It adds: "As the market matures, the spotlight will increasingly shift to the trading of PFI investments. Most of the contractors surveyed did not know or would not say whether they will hold onto their investments for the full 25 to 30 years."

A range of investment funds have been established specifically to take on existing PFI investments, including some run by Barclays Capital, Henderson Global Investors, Innisfree and the Secondary Market Investment Fund (Investors Chronicle, 2nd June, 2004). Other fund managers and merchant banks are thought to be interested in entering the market. There has now been a flow of sales (see below).

4.4 Special purpose vehicles

Special purpose vehicles (SPV) are companies created for a particular purpose and often have no assets. For PFI contracts, these SPVs are created to bid for the contracts and they are legally the contractor that the public body deals with. The shareholders in the SPV are the construction and service contractors, plus, perhaps, the project investors and, often in the case of PPPs, the public body awarding the contract.

PricewaterhouseCoopers ('Study into rates of return bid on PFI projects') specified three reasons why SPVs were used by contractors for PFI projects. As stand-alone companies, if the SPV collapses there is no financial liability falling on the companies which set it up beyond the value of their shareholding and any guarantees which they might have provided. Shareholders usually each own less than 50% of the SPV and so have no need to show its assets and liabilities on their own balance sheets. By using a name which is unconnected to that of the shareholders the contracting companies achieve what is called 'bankruptcy remoteness' in the event of commercial failure on the part of the SPV.

An example of the structure of a Special Purpose Vehicle (SPV)

Octagon Healthcare (Norwich) Holdings Ltd
- the SPV providing the Norfolk and Norwich hospital PFI

Owned by

Barclays UK Infrastructure Fund
(controlled by Barclays Private Equity, a division of Barclays Capital, itself a division of Barclays Bank PLC)

3i Group

(an investment fund)

Innisfree PFI Fund
(a PFI specialist investment fund)

John Laing Investments
(a division of John Laing PLC)

Serco Investments
(a division of Serco Group PLC)

Source: Octagon Healthcare website, July 2004

SPVs have a bad name. Enron, one of the world's largest companies, collapsed as a result of inflating its profits by entering into rigged contracts with its own related companies - SPVs - to offload debts and loss-making contracts, while failing to report the loss-making situation of these SPVs on the group balance sheet. But even without such dubious financial devices - and prosecutions are currently underway in the United States against Enron executives - SPVs should come with a health warning.

By contracting with the public sector through SPVs, contractors are able to turn their backs on a difficult or unprofitable contract, possibly without incurring financial penalties. Because the SPV is likely to own no assets of its own, contract failure may not lead to the enforcement of any penalties agreed as part of the contract.

4.5 Who owns public assets?

The development of refinancing, the secondary market and the use of SPVs, means that the trading of PFI asset ownership is taking place without reference to the public interest or the possible impact on public services. This process has been reinforced by the forced sale of assets, contracts and trading contractors through the weak financial situation of several of the PFI specialist businesses.

There is a view, as put forward strongly by Innisfree (File on Four, see below), that the public and the Government should have no anxiety or right to know about the ownership of assets that are used to deliver public services. UNISON strongly disputes this view.

The contract awarding process does not simply assess the quality of bids and bid price. It also considers the competence of tendering organisations to deliver the procured services. Subsequent transfers of ownership make a mockery of the PFI and PPP contract awarding process. In the case of Tube Lines, for instance - responsible for the running and improvement of the Piccadilly, Jubilee and Northern lines on the London Underground - at the time the contract began operation in 2003 it was owned jointly by Bechtel, Amey and Jarvis. Amey has since been bought up by a Spanish company, preventing its potential collapse, while Jarvis is expected to be forced into a sale of its stake. It seems likely that in a period of a little more than a year, two-thirds of the members of the consortium will have effectively changed. If this happens in a year, what will happen over the 20 to 30 year lifespan of the PFI/PPP contracts across the whole of the public sector?

Several PFI specialists have made significant use of the emerging secondary market, sparking a big change in ownership of assets and interests:

- "The market finally got rolling last year," reported the Investors Chronicle on 2nd June 2004. "In January, John Laing bought Amey's portfolio for £29.1m [but taking on debt, raising the cost of the acquisition to £43m]. In November, Carillion sold its 30 per cent stake in the Darent Valley hospital to Barclays Capital. In December, Mowlem sold its 40 per cent stake in part of London's Docklands Light Railway to Infrastructure Investors LP for £19.4m, generating a £15.6m profit." The magazine added that construction companies - keen to raise finance for new projects - were more likely to sell their stakes than were facilities management companies, keen to retain influence that might benefit them for the duration of the contract. Carillion's sale of its stake in Darent Valley generated a one-off profit of £11m for the company. (Investors Chronicle, 28th November, 2003)

- Balfour Beatty is one of the PFI contractors that has disposed of PFI investments. In its last financial year (the calendar year 2003) it obtained exceptional profits of £5m from these disposals. However, the company said it would not be entering the secondary market. (Birmingham Post, 11th March, 2004)

- Kier Group is reported to be "interested in selling off some of its concessions" (Birmingham Post, 23rd March 2004). John Laing's chief executive, Andy Friend, was also quoted as saying the secondary market "is an interesting area" (Birmingham Post, ibid.). He was elsewhere (Daily Telegraph, 23rd March 2004) quoted as saying that the company "would consider selling down our stakes but are unlikely to fully exit". Friend added that the secondary market is more mature in Canada and Australia and that it was an attractive investment class for insurers and pension funds.

- There is a difference of approach between PFI specialists about whether their shareholdings are long-term or short-term (reflecting, to an extent, the differing commercial interests of construction and service provision companies). Serco, a facilities management group, has bought out the interests of two joint venture partners in PFI deals and purchased five other PFI contracts through its acquisition of the Premier Custodial Group. Serco's executive chairman, Kevin Beeston, reported in February 2004 that Serco are "enthusiastic but selective participants in PFIs". He added: "The emergence of a secondary market in PFI equity and debt confirms that the value of PFI stakes is now well recognised and realisable. However, our strategy is generally to retain our stakes as we expect to generate further long term value from the operating contracts." (Serco Group's preliminary results for year ended 31st December 2003)

- PFI contracts owned by Melville Dundas were sold by the company's receivers, Ernst & Young, to Dawn Construction, after Melville Dundas became bankrupt. The contracts included a number of higher education schemes. (UNISON briefing, June 2003)

4.6 Secrecy

The character of PFI schemes hides their reality from public gaze. Despite the use of public money, there is a veil of secrecy and a failure of accountability cloaking PFI and PPP contracts. This has been repeatedly commented upon by House of Commons' select committees and others. This makes it extremely difficult to determine whether value for money has been achieved. Unison's report 'Public risk for private gain?' emphasised the general absence of analysis of actual risk transfer absorbed by PFI contracts and the cost that this involved.

In addition to the opacity of the original PFI and PPP contracts, we now have the additional obstacle to transparency and accountability of the secondary market. Investors are not only operating outside of the light of publicity, they also see no reason why the public should be informed.

“The chairman of the Public Private Partnership Forum, David Metter, whose own company [Innisfree] has recently bought a large shareholding in more than 20 schools argues that the PFI shares market should be like any other, and that investors should be free to take their own profits,” reported BBC Radio 4’s File on Four programme. “ ‘These are not public assets but private sector concessions,’ says Mr Metter. ‘So during the period of concession the private sector effectively owns the school or hospital.’ ” This view is likely to shock parents of school children and patients of NHS hospitals.
Conservative MP and Public Accounts Committee member, Richard Bacon, argued on the programme that there was too little transparency in the contracts for taxpayers to be able to judge whether value for money had been achieved. Given that the National Audit Office has also on some occasions had great difficulty in reaching a conclusion, Mr Bacon might not have limited his comments to taxpayers being in the dark - even the auditors seem to be.

“My own view is that if you are a contractor taking money from taxpayers for providing services you have to accept that it entails on your part a higher degree of disclosure and a higher degree of transparency than would be the case if you are operating in the purely private sector,” Mr Bacon told File on Four. "People have to accept that if they're going to take the taxpayer's shilling, they have to be transparent."

4.7 Complexity

Complexity is the second cause of the lack of transparency. In part this is the symptom of two sides each trying to quantify risk and minimise risk acceptance for themselves - resulting in often incredibly complex contracts.

The most outrageous example of this is the London Underground PPP contracts. In his book ‘Down the Tube’, leading transport analyst Christian Wolmar refers to “transport experts who have almost unanimously declared [the Underground PPP contract and clauses] unworkable.” Wolmar concluded that the PPP cost at least £400m to set up, involves 135 volumes and 28,000 pages of contracts and depends for its operation on contracts of Byzantine complexity. He also, incidentally, reached the view that the PPP will fail in its objective of guaranteeing the Tube a stable, long-term funding that was originally its principal attraction, will deliver little of the private money that was promised, leaving the taxpayer with an annual bill of £1bn, with every possibility of funding gaps in the future, that they passed the value for money test obligatory for all PFI schemes only with the help of transparent financial sophistries, split up a unified system with consequent increases in management costs and greater risks to safety and transfer very little financial risk to the private sector.

“I set out on the research for this book in the genuine spirit of inquiry,” wrote Wolmar. “Listening to London Underground's argument in favour of the PPP there were moments when I thought it might have merit. Or at least I did for an instant. But as the explanations led on to further complexities and explanations, I just wanted to say, in the words of John McEnroe, ‘You cannot be serious.’” (From ‘Down the Tube’)

Tim O’Toole, managing director of London Underground, says that the problems were multiplied by imposing PPPs above existing PFI contracts, which were never designed to fit together. “These PFIs and the PPP were not planned or designed to work together to London Underground’s advantage, with the consequence that the public sector is exposed to significant cost risk,” he says (‘London Underground and the PPP: the first year, 2003/4’).

“The complexity of the PPPs resulted from the scale of the deals, innovative output specifications and a limited knowledge of the condition of some assets,” reported the National Audit Office (press release, July 2004). “The resulting deals offer the prospect, but not the certainty, that improvements will be delivered.”

4.8 'Not for profit contractors'

The public sector has, in some instances, required contracts to be fulfilled by 'not for profit' contractors. However, this arrangement cannot necessarily be taken at face value. "Even if for political reasons a contract may be designated 'not-for-profit', construction and/or service contracts can be negotiated as stand-alone contracts, and can then be profitable in their own right," says Standard & Poor's (PFI projects, ibid.). Despite losing the opportunities to obtain dividends as a shareholder in a PFI SPV, lead and sub contractors can still earn profits from service contracts and benefit substantially from using the SPV's cash flow to their benefit. (S&P)

4.9 The Government's fictitious balance sheet

The latest official Treasury figures show 626 PFI projects had been signed by the end of April 2004, to the value of about £40bn. However, this understates the significance of the sector by omitting PPP contracts, as well as being slightly out-of-date. In January 2003, the UNISON report 'Stitched Up', quoting Financial Times' Treasury comment, said that the total of PFI plus PPP contracts was around £100bn.

Ernst & Young ('PFI grows up', ibid.) stresses the continuing significance of PFI projects and predicted that education would see a big increase in PFI projects (one respondent said we have "just seen the tip of the iceberg" so far in the sector). It predicted limited growth in the transport sector and little interest in social housing.

According to analysis by a House of Commons research paper, the Treasury figures appear to only refer to the capital values of the projects. ('The Private Finance Initiative', 2001) At the time the total of the capital value of the first 450 PFI contracts, using Treasury figures, was £20bn. The report added: "PFI projects signed to date have committed the Government to a stream of revenue payments to private sector contractors between 2000/1 and 2025/6 of almost £100bn." This figure may now stand at about £200bn, given that the capital value of signed PFI schemes has since doubled to £40bn.

Strong growth in urban regeneration schemes structured as PFI contracts is predicted by Ernst & Young. This view seems confirmed by the signing by Capita of a 12 year £250m regeneration scheme with Salford City Council, following previous contracts with Blackburn, Cardiff and Cumbria (Times, 23rd July 2004).

The Treasury has made much of its claim that 60% of PFI deals are 'on balance sheet' and that whether a scheme is on or off balance sheet is not relevant to a decision on whether the project should go forward. This has not satisfied sceptics and in any case downplays the fact that 40% of deals are 'off balance sheet' - removing at least £16bn of liabilities from the Government's accounts.

However, as the Financial Times' Philip Stephens commented in 1996 (quoted in the House of Commons' research paper, 'The Private Finance Initiative'), "We know that, like all off-balance sheet spending, the PFI flatters the official accounts. Future liabilities do not show up in the accounts."

The real problem is that the real level of off-balance sheet financing - almost by definition - is unclear and adds to the level of opacity connected to the use of PFI and PPP. The House of Commons' Treasury Committee made clear its concerns about this back in 1996, yet the matter remains unresolved.

Even more significantly, taking debt off balance sheet for the Government comes at a huge price. The cost of the planned Crossrail link for London, for instance, rises in cost from £10bn to £12bn if the debt is taken off balance sheet (Financial Times, 12th July, 2004, based on a leaked but confidential report produced by the Greater London Authority).

These extra costs are mirrored by actual major infrastructure projects. The National Audit Office reported in relation to the London Underground PPPs, "Although repayment is at least 95% guaranteed by the public sector, borrowing comes at a cost of some £450 million more than direct Government borrowing."

A similar issue arises with the public interest company, Network Rail. Some £21bn of loans to Network Rail are treated as off balance sheet by the public sector accounting arbiter, the Office of National Statistics - though the National Audit Office took the opposite view. The House of Commons Treasury Select Committee has called for "greater transparency".

The Government appears itself to be caught trying to achieve two irreconcilable objectives - take the debt off for statistical and fiscal purposes, but keep it on to reduce the cost of Network Rail's debt. "Network Rail plans to raise £14 billion of new 20-year debt, the extra financing costs of a BBB rating versus AAA [the difference between private sector and government debt] could amount to £2.8 billion," wrote the Daily Telegraph (19th November 2002).

These are issues that go beyond PFI, PPPs and the transport sector. The Nuclear Decommissioning Agency has liabilities of £51bn, comprising £3.9bn taken on by the Government from British Energy, plus £48bn from British Nuclear Fuels Ltd. It is unclear whether these liabilities will be on or off the Government's balance sheet. (Public Finance, 17th October 2003).

The fact that when the privatised British Energy hit the commercial buffers it had to be bailed-out by the Government to this extent underlines the fact that in the matter of essential services - and the management of nuclear waste is certainly an essential service, whether or not nuclear generating capacity is maintained - remains a matter for government to ultimately underwrite. This, in real terms, is unaffected by whether a service has had responsibility transferred under contract under the PFI, or if it has been privatised.

4.10 Long term revenue commitments

The long-term character of PFI contracts commits the Government to large-scale revenue expenditure for many years ahead, limiting the room for manoeuvre of future administrations.

Analysis conducted by the House of Commons library in December 2001 suggested that, even then, forward revenue commitments under the PFI was in excess of £100bn. Given that the capital value of signed PFI contracts has doubled since then from £20bn to £40bn, the forward revenue commitments will also have risen substantially - perhaps also doubling. Revenue costs in each year until 2012, according to these 2001 figures, was planned to exceed £4bn in payments by the Government, in some years exceeding £4.5bn. ('The Private Finance Initiative', House of Commons library)

A strong profit stream for the contract company is effectively a gift from the public purse: the collapse of the contractor *can require the public body to step-in and rescue the asset and service which the contract was established to build and operate. The public sector loses either way.*

4.11 Contractor failures

The fact that PFI contractors often achieve massive profits must not distract attention from the serious financial problems facing some of the companies. The experiences of Jarvis, Amey and Ballast should be treated as a warning. PFI and PPP contracts can generate substantial profits for specialist companies, but contract failures can be seriously damaging for public sector clients. The problem for the public sector is that it risks losing either way. A strong profit stream for the contract company is effectively a gift from the public purse: the collapse of the contractor can require the public body to step-in and rescue the asset and service which the contract was established to build and operate.

Contractors are exposed to several risks endemic to the PFI sector:

1. Construction companies which may be lead PFI contractors may not have sufficient skills in the pricing of contracts. "Failure to accurately model inflation, costs, cash flow, and economic activity over the long term can easily result in losses for the project manager or the sponsors, as demonstrated by Amey PLC's loss on the Croydon Tramlink, which contributed to its takeover by Spanish construction company Grupo Ferrovial SA," reported Standard & Poor's ('PFI projects', ibid).

2. Construction companies which are not used to dealing with high debt burdens may find themselves exposed in the event of economic downturns to servicing debt while receiving less income than was predicted.

3. Accounting standards for PFI-type contracts changed in 2002 (Urgent Issues Task Force 34), which ended the practice of capitalising bid costs except where a company has achieved at least 'preferred bidder' status. The capitalisation of bid costs was previously a widespread practice. If bid costs are treated as revenue expenditure they have an immediate and single year impact on company profitability. If they can be treated as capital costs, they can be written off over a number of years, thereby improving a company's declared short-term profits. The change in accounting practice had the effect of damaging the reported profitability of some PFI specialist companies, reducing City confidence. This was most famously true of Amey. It was noticeable that when Laing purchased PFI equity stakes from Amey, that Laing disputed the claimed profitability of Amey's share portfolio - pointing out that using Laing's accounting practices the profit recognition would have been lower. (Daily Telegraph, 22nd January, 2003)

4. Contractors may sign a fixed price contract with a public body under a PFI arrangement, before they have finalised terms with sub-contractors. They then become vulnerable where sub-contractors seek better terms than was assumed in the lead contractor's business plan. According to Standard & Poor's ('PFI projects', ibid) dispute between lead and sub contractor over terms led to problems in implementing the Dudley NHS hospital build project.

5. A limited pool of sub-contractors. Just as public bodies have a restricted supply of prime contractors from which to seek PFI contract tenders, so, too, prime contractors have a limited number of reliable sub-contractors from which to draw. This limits their room for

manoeuvre where sub-contractors' performance is poor in fulfilling a PFI contract, where they may be subject to penalties for poor performance. It also provides practical difficulties where a prime contractor fears that a sub-contractor may be on the verge of business collapse.

5. *Case studies*

5.1 Tower Hamlets

The London Borough of Tower Hamlets awarded a £120m contract for the refurbishment of 27 schools to a consortium that operated as a Special Purpose Vehicle called Tower Hamlets Schools Ltd. The prime contractor behind the successful bid was Ballast PLC, a subsidiary of a major Dutch group Ballast Nedam Infra B.V., with facilities management to be supplied by a subsidiary of the UK Ballast company, Wiltshier, and finance supplied by a subsidiary of Abbey National bank, Abbey National Treasury Services. The initial contract was awarded until 2007. But Ballast PLC ceased trading in October 2003, after recording a half year loss in excess of £10m and a previous full year loss of £35m, with a pensions deficit on its balance sheet of about £25m. By closing the subsidiary, its parent Dutch company abandoned the Tower Hamlets schools contract and a £45m contract to redevelop six schools in East Lothian. (Guardian, 15th October, 2003) Wiltshier also closed as a result of the Dutch parent company's decision.

The company closures disrupted Tower Hamlets' school building programme. But this was exacerbated by a coincidental decision by Abbey National to withdraw from the PFI market, as a following poor results from its investment banking operations.

The combined effect has been "severe disruption due to the delays in the major construction works programme", leading, said head teachers, to management and organisational problems, "impact on pupil behaviour and morale, and impact on staff morale", it was reported in a confidential Tower Hamlets committee paper in June 2004. The committee report added: "The demise of Ballast plc did mean that the schools received a very poor standard of hard facility management services for some time…… The collapse of Ballast plc meant that some schools were left in the unenviable and extremely difficult circumstance of having a significant proportion of their facilities being a building site, with no building activity taking place."

Compensation of £8.2m has been paid by Ballast plc's parent company, Ballast Nedam, but even if this is calculated as providing recompense for financial losses to date, this does not compensate for the service disruption.

The unilateral withdrawal of Abbey National's subsidiary Abbey National Treasury Services (ANTS) from the PFI finance market is in its own way just as concerning. The Tower Hamlets report makes clear that the SPV, Tower Hamlets Schools Ltd, reached an agreement with ANTS on the conditions for withdrawal, without the involvement or agreement of the council. Compensation was agreed between ANTS and Tower Hamlets Schools Ltd without the involvement of the local authority and compensation paid into the control of Tower Hamlets Schools, not the council.

"This exposes the council to the risk that should TH Schools take a strategic decision to default on the contract, it might decide to provide as little service as possible, whilst taking as much cash as possible out of the contract." (Tower Hamlets committee paper). Despite the intervention of Partnerships UK, ANTS is reported to have refused to alter its position of withdrawing without first ensuring that refinancing is in place. As one role of the financier is to accept project management financial risk, the withdrawal of ANTS transfers risk to the council without the council receiving compensation for this.

The overall impact of the ANTS withdrawal and the Ballast collapse has been to increase the cost and perceived risk of the Tower Hamlets school build project. While Tower Hamlets is in no way to blame for this, it has had to increase the fees it pays to TH Schools to prevent the risk of them walking away from the project. It is therefore clear that the agreement of a PFI contract neither fixes financial commitments in stone, nor does it provide certainty over the realities of risk transfer.

5.2 Jarvis

Jarvis has been badly damaged by its responsibility for the Potters Bar rail accident, which led to it withdrawing from the UK rail maintenance business. Even before the signs of real crisis in early and mid 2004, Jarvis was reportedly having difficulty in performing on contracts. This is potentially very damaging to the PFI/PPP market, where Jarvis is one of the largest providers holding about 10% of service contracts by value.

“At one Jarvis-built school in Scotland, storm damage to the roof was left unrepaired for a month while the local authority waited for the company to fulfil its maintenance obligations,” reported Ireland’s Sunday Tribune. “Eventually the local authority was forced to repair the damage itself.”

A contract held by Jarvis to re-roof schools in the Wirral during 2003 hit serious delays when workers walked off the site, claiming they had not been paid for two months. That, together with other problems on the contract, led to schools being closed over the summer for an extended period, disrupting children’s education. (Independent, 9th July, 2004)

Jarvis’s accommodation division, Jarvis UPP Holdings, paid compensation of £120,000 to 400 Lancaster University students because of delays in providing new halls of residence. (Financial Times, 31st May, 2004) Brighton City Council said in February that the quality of Jarvis’s work on redeveloping four schools was “unacceptable”.

Like Amey, it is also perceived to have been over-optimistic in its accounting practices in declaring profits too early in the term of contracts: former auditor PricewaterhouseCoopers resigned in 2000 quoting the “aggressive approach to recognition of profits on long-term contracts” (Daily Mail, 7th July, 2004). One analyst was quoted as saying that Jarvis had previously been “declaring supra-normal profit margins” (Contract Journal, 4th February, 2004).

The company ended up with debt of £230m, but annual profits of less than 10% that figure. As part of a strategy of renewal, Jarvis has begun to call the group ‘Engenta’ and has successfully bid for contracts under the name ‘Prismo’. The Jarvis Primary Health Company, a joint venture with the Montrose Partnership, changed its name to PatientFirst Partnerships earlier this year (Financial Times, 19th February, 2004). But Jarvis remains an extremely important player in the PFI/PPP market in particular as one-third owner of Tube Lines, which runs several London Underground lines under a massive PPP contract.

Jarvis angered the City by issuing two profit warnings in 2004. Its share price fell from just under £4 in the middle of 2003, to 22 pence by July 2004. It is now vulnerable to a takeover, and the aggressive US investment fund K Capital has become the company’s largest shareholder. Some analysts believe that K Capital has bought Jarvis shares in the expectation of a break-up of assets, which the fund calculates as now worth more than the business.

Kier Group, one of Jarvis’s most consistent competitors in the PFI market, has said that it hopes to pick up more contracts as a result of Jarvis’s problems. (FT, 16th July, 2004) Not only does Jarvis’s problems worry public bodies in the UK, but also in the Irish Republic where the company has several education building contracts. (Sunday Tribune, 11th July, 2004)

Yet even while Jarvis was apparently teetering on the edge, new contracts were being awarded to it - in June 2004 it signed two contracts, one with the London Borough of Croydon for a new school and library and a second through the Jarvis UPP Holdings subsidiary to manage and operate two Plymouth University halls of residence. (Company News Feed, 2nd June, 2004)

6. Potential impact of further contractor failures

While there is unhappiness at the massive profits accruing to some PFI contractors, the potential decline of leading PFI contractors is just as worrying. This is a particularly serious concern given the constraints on the public sector itself to pick up the pieces by stepping in to take on the asset and service provision. Those constraints are financial, practical and logistical (in the sense that relevant skills have in some instances been sucked out of the public sector). These need not be permanent disqualifications from the public sector taking over failed private contractors, but they may be a bar to public bodies immediately stepping in to a vacuum left by a private contractor that ceases trading.

6.1 Disruption of existing services

There has been much media speculation about the impact of a possible Jarvis collapse. Yet the Financial Times (9th July 2004) concluded that "there's no place for panic". The FT's view reflects the attitude of bankers who say that contracts fully cover all contingency risks, including that of provider collapse. Yet the experience of Ballast - in Tower Hamlets, for example - strongly suggests that there can be significant disruption in contract delivery and a risk that the public body will end up having to pay a higher price for services than was originally agreed in the contract.

In theory during the construction process, the financiers must pick-up the risk to ensure facilities are constructed as promised. (Though the Ballast/Tower Hamlets experience on this, too, suggests a possibly flawed outcome.) According to the FT, if a service provider fails during the service delivery element of the contract, it would be up to the investors to find a replacement service contractor. This view on the part of the FT appears to assume that the banks would ensure that the SPVs continue in existence, as was the case with the Tower Hamlets Schools experience.

As a supposedly positive solution, the FT referred to the experience in East Lothian, where the collapse of Ballast caused school building work to be halted in October last year and was resumed in March this year. While the FT claims that the public sector client did not pay any extra as a result, it is still obvious that there was a five month delay in construction work. It should be stressed that five months is a long time as a proportion of a school's academic year.

Impacts of Jarvis's collapse could be particularly severe if there is difficulty in finding replacement primary contractors.

6.2 Contract price hikes

We have already seen following the Ballast closure that potential replacement contractors have argued for a need to increase charges. Similarly, Kier argues that it is unwilling to simply step into the shoes of Jarvis should it cease trading as its risk profile in existing contracts was too high.

Logic suggests that no company is likely to rush in where an existing contractor has failed. Potential replacement contractors may well argue that they need to ensure the viability of an arrangement through higher prices. They may legitimately argue that they may have to meet higher overheads: eg taking on administrative problems, inheriting arrangements that are alien to that company's working practices. Equally, the removal of the successful tenderer by its nature reduces competitive pressure and withdraws from the previous tendering process the keenest bid. It is almost certain that contract prices will rise and public sector procurers in these circumstances have limited ability to argue against this. So much for risk transfer and cost certainty under PFI.

"The industry knows that they increasingly hold the whip hand vis a vis the public sector" *Ernst & Young.*

6.3 Restrictive competition

There are real concerns that the thinning out of PFI providers is damaging what was already an imperfect PFI market. Further closures amongst PFI specialists is likely to mean that for some tenders there are insufficient bidders to generate real competitive pressure. Another parallel danger is that as the number of market players thins out, so the few companies remaining will be left with unacceptably large market shares.

"Confident that foreign competition is not an issue, the industry knows that they increasingly hold the whip hand vis a vis the public sector," Ernst & Young reports ('PFI grows up', ibid). "The government is discovering that its appetite for PFI is not matched by that of suppliers - the evidence is that tenders are not being picked up."

This view is apparently supported by Standard & Poor's ('PFI projects', ibid), which refers to an emerging split between the few construction companies able to project manage major projects and the majority who do not. (S&P names just three UK companies, Amec, Balfour Beatty and Carillion, plus two German, two Spanish and one Swedish contractors, able to project manage major schemes.) As S&P also points out, the trend towards larger PFI contracts in a market dominated by a few specialist companies means that there are now very high barriers to market entry.

The Government is particularly worried that there are too few players in the market to refurbish schools and that this could jeopardise its programme to refurbish all of England's secondary schools. Companies are reported to have advised the Government that they may not have the capacity to fulfil this. "It is a concern and it has been rightfully identified," said a spokesman for Partnerships for School, the public agency leading on the programme. (Independent on Sunday, 11th July, 2004)

Concern about the limitation of competition is felt not only by PFI/PPP opponents. Tim Stone, chairman of KPMG's PPP Advisory Practice, said that the Government had to operate the market effectively in terms of controlling the timing of tenders and contract awards. The risk was that "they will put 20 schools out to tender along with five hospitals all on the same day and the contractors and bidders will simply divide them up between them." (Financial Times, 11th March 2004). Indeed, he warned, there were concerns that the Government might, through its extension of hospital and school building programmes, flood the market's ability to cope with the demand. "They could require as much as an additional £6bn/£7bn a year of investment, which should be compared with the maximum the National Health Service has ever achieved of about £1bn a year. Such a massive increase will not be easy to achieve - yet similar demands will arise across the whole spectrum of public services." (Tim Stone, writing in the Financial Times, 11th March 2004).

Reduced competitive pressure means that companies have been able to increase profit margins in recent years, "cherry pick" (as analysis from Ernst & Young described it) and turn their backs on unfavourable contracts. There is a strong possibility that other contracting companies will argue that Jarvis's potential failure has been brought about by accepting contracts on terms that were not sufficiently generous. Signs of this emerged early in July when Balfour Beatty warned that it was not interested in taking on school building and maintenance contracts on the grounds that they are "too risky" (Independent , 12th July 2004).

Another risk factor for the public sector is that a reduced competitive environment limits public bodies' scope in their choice of contractors, on quality grounds as well as price. Companies that public bodies ideally might wish to avoid may have to be chosen. And despite awareness of the financial vulnerability of tenderers - including rumours of possible demise - limited competition may force public bodies to award contracts in the face of the risk of imminent closure on the part of the winning tenderer.

6.4 Pensions liabilities

It is not entirely clear what impact further contractors' closures might have on staff pension rights. There must be concern that workers may not find themselves properly protected in the event of contractor failure if the pension scheme has not been adequately funded. It is hoped that the Pensions Protection Fund, proposed in the Pensions Bill, will go some way towards covering this.

6.5 London Underground

Closure or the sale of Jarvis as a going concern might have little effect on Tube Lines, one of the two consortia holding giant PPP contracts for the improvement and running of the London Underground. Tube Lines consists of three sponsors: Jarvis, Amey and Bechtel. Jarvis is currently on the brink, while Amey had to be rescued last year. There is now the prospect of two of the three sponsors fundamentally changing in character in the short period since the PPP contract was initiated in April last year.

But transport analyst Christian Wolmar doubts that a closure or sale of Jarvis would have a serious or damaging impact on Tube Lines. Rather its stake in Tube Lines is probably the factor that will enable Jarvis to continue trading (in some form, probably through sale) rather than be forced by its debts to close. "It underlines the fact that the PPP was a licence to print money," says Wolmar. "This will help to save them. It's more than a scandal: it's a disgrace." (Christian Wolmar, in conversation)

This view is given credence by analysis from two reports in June 2004 from the National Audit Office, which concluded that the PPPs may not provide value for money. The NAO said "there was limited assurance that the price of the three Tube PPPs was reasonable". Total contract value, across the consortia's contracts, has a present value of £15.7bn. "If they deliver performance at bid levels private sector shareholders stand to receive nominal returns of 18-20 per cent a year," said the NAO report. "This is about a third higher than on recent PFI deals but London Underground considered that it was in keeping with the risks being borne. If the private companies achieve the lower performance levels set by benchmarks, their real returns would be between 10 and 17 per cent a year."

7. Conclusions

Widespread concern about the use of PFI and PPPs has not translated into a general understanding of how they operate. This is largely the result of the complexity, secrecy and lack of accountability involved in PFI/PPP contracting.

It should be no surprise that the Government's use of PFI and PPPs to introduce the private sector into the provision of public services has brought with it the two systemic market failings: the inequity of profit distribution and the fall-out of business collapse. The public sector is paying the price for both - it is paying for the mega profits and bailing-out the failed contractors.

This matters not just because it is unfair that some contracts are "a licence to print money", as transport analyst Christian Wolmar puts it. Public services depend on continuity and consistency. This study has referred to the problems caused to school pupils when a school building is delayed by the business collapse of the prime contractor. Can we be confident that a comparable crisis on the part of a hospital's facilities management contractor would be resolved with sufficient speed that patients' health will not be put at risk?

Bankers have repeatedly argued that such concerns are unwarranted. The financial backers, they point out, take the ultimate risk by guaranteeing contract delivery. But we have seen what happened in Tower Hamlets when a bank, Abbey National Treasury Services, itself withdraws from a PFI contract. There is, it seems, a contractual loophole when both prime contractor and lead investor simultaneously withdraw from a contract.

One lesson of the PFI experience - which should also have been drawn from the privatisations of Railtrack and British Energy - is that whatever contractual arrangements the public sector enters into, the Government remains the guarantor of last resort for essential public services. Contracts that specify risk transfer are not reflecting the realities of the situation. Yet the public sector is paying vastly more - running into many billions of pounds across all of government - to maintain the pretence that risk is actually being transferred.

Asset ownership, though, actually has been transferred. We should - according to Innisfree, one of the largest PFI investors - no longer think of public assets, but instead of private concessions. But with what might be regarded as a logical inconsistency, Innisfree also sees no reason why the public should be aware of who in the private sector has the concession. Such is the flawed accountability of PFI and PPPs.

Whatever happens to Jarvis, the opportunity must be grasped to take a fresh look at the full range of service delivery implications of PFI and PPPs. There is a real danger that the collapse of Jarvis or another leading PFI/PPP contractor could seriously disrupt vital public service delivery. Contract default arising from a collapse could cause the public sector to pay even more for the assets and services it has already negotiated a price for. And the cost of future contracts could rise ever higher as the range of suppliers reduces further.

There is no such thing as a perfect market, but the PFI/PPP sector is more flawed than most. The trouble is that it is the public which is paying the price for both the fat cats and the catastrophes.

8. *Resources*

Title	**Stock No.**
Public Risk for Private Gain?: *The public audit implications of risk transfer and private finance July 2004*	*2350*
Not so Great: *Voices from the front-line at the Great Western PFI Hospital* (Oct 2003)	2255
What is Wrong with PFI in Schools (Sep 2003)	2251
LIFT: *Local improvement Finance Trust*	2235
The PFI Experience: *Voices from the front line* (March 2003)	2187
Profiting from PFI (February 2003)	2158
Stitched Up: how the Big Four Accountancy Firms have PFI Under their thumbs (January 2003)	2147
PFI: Failing our future: A UNISON Audit of the Private Finance Initiative (September 2002)	2108
A web of Private Interest: *how the Big Five accountancy firms Influence and profit from privatisation policy* (June 2002)	2092
What's Good about the NHS: *and why it matters who provides the service* (April 2002)	2053
Debts, Deficits and Service Reductions: *Wakefield Health Authority's legacy to primary care trusts* (April 2002)	2034
Understanding the Private Finance Initiative*: the school Governor's essential guide to PFI* (January 2002)	1967
Challenging The Private Finance Initiative *Guidelines for UNISON Branches and Stewards* (May 2000)	1763
Contracting culture: from CCT to PPPs: *The private Provision of public services and its impact on employment Relations*. by Sanjiv Sachdev, Kingston University (November 2001)	1964

Al l reports are available from UNISON Communications or from the UNISON website

Websites

UNISON has a special page on its website devoted to PFI www.unison.org.uk/pfi

as part of UNISON's Positively Public campaign www.unison.org.uk/positivelypublic