INSTITUTE MEMBERS IN SCOTLAND

7 December 2007

Allan Campbell
Assistant Clerk
Finance Committee
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The Scottish Parliament
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Dear Mr Campbell

Finance Committee Inquiry into Public-Private Partnerships

The Institute Members in Scotland Group is pleased to have the opportunity to submit initial evidence to the Finance Committee's Inquiry into the funding of capital investment projects. As noted in the scoping paper prepared by the Scottish Parliament Information Centre (SPICe - Paper No FI/S3/07/04/2) the Welsh Assembly is currently undertaking a review of Public Private Partnerships (PPP). The Institute has made a similar submission to that inquiry. In November 2006 the Institute's Corporate Finance Faculty published a Best Practice Guideline on Private Finance Initiative, authored by David Steeds, Director of The PFI Infrastructure Company plc. The Guideline sets out in some detail the rationale for existing schemes and the technical considerations. This document has been sent to SPICe to be made available to interested parties.

The Institute Members in Scotland Group represents over 1,300 members of the Institute of Chartered Accountants in England and Wales who live and work in Scotland. Our members operate across all sectors of the economy in Scotland, as all 129,000 members of the ICAEW do in the UK and overseas. Our members have experience of the operation of financing schemes for public sector assets both from the contractor and client perspective and they have been heavily involved in all aspects of PPP/PFI deals across the United Kingdom.

General Points

It is in the interests of the taxpayer, and of the Scottish economy as a whole, that public goods and services are procured and paid for in a way which provides the optimal balance between value for money and efficiency. In many ways current funding schemes such as PFI and PPP have required a trade-off to be made. The benefits of applying the discipline of private sector management to major public projects and the transfer of risk are secured but at the cost of raising finance at a rate higher than that typically incurred by Government when borrowing.

PFI/PPP schemes undoubtedly have a place in meeting the demands of infrastructural development and they have been used extensively in Scotland. Many of these projects have been an unqualified success with high quality infrastructure being built to support the improved delivery of public services in Scotland.

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Other schemes however have been less successful and it is appropriate that lessons be learned from these less successful initiatives. It is unfortunate that these schemes have attracted a disproportionate share of adverse comment and criticism but it is important that a proportionate view is taken. The PFI/PPP concept now has a reasonably long history and both advisors and the public sector have shown considerable ingenuity in identifying innovations and modifications that significantly enhance their effectiveness of the schemes. A number of these innovations have been developed in Scotland by Scottish institutions and we believe it is important that any changes in approach introduced by the Scottish Government do not unduly constrain innovation in the future by prescribing a particular approach or model and excluding others.

We would now like to highlight specific areas that might inform the Committee's deliberations.

Operation of PFI projects

Although more than six hundred PFI projects have been approved across the UK, relatively few have operated for more than a small proportion of their overall term (which is often 30 years or more) and so the evidence base is limited. Initial views from the public sector clients are largely positive and PFI contracts have been used to improve service provision in a wide range of different public sector areas such as roads, hospitals, and schools. It is debatable whether such a level of investment would have been possible without these innovative funding methods.

The SPICe scoping paper cited above highlights findings by Audit Scotland and the Scottish Executive but numerous other studies have been undertaken including in excess of 50 reviews by the National Audit Office (NAO). Notwithstanding that the financial arrangements in respect of some of these deals has been the subject of critical comment, there does seem to be general agreement that significant improvements, in terms of buildings being completed on time and to budget under PFI compared to the historic performance of traditional public sector procurement, have been seen. The NAO noted in 2003 that almost three quarters of projects procured under traditional methods came in over budget or late, compared to less than a quarter of projects procured via PFI.

However there are some disadvantages to PFI. The process of entering into a PFI deal is complex and procurement timescales can be significant. In addition changing a deal once it has been entered into can be difficult and contractual terms are relatively inflexible. It is sometimes argued that this type of problem reflects a fundamental flaw in the PFI approach but many schemes have continued to operate effectively as time passes and caution is needed before being unduly critical of schemes that have failed to anticipate future needs and requirements. The pace of social and technological change is very rapid and it is excusable that in some cases participants have failed to accurately foresee all possible changes in circumstances.

The most common objection to PFI is that the private sector partner will demand a profit margin and that this represents a cost to the public purse. Undoubtedly a private sector partner will demand a premium both to compensate for the risk that they have assumed and to reflect their own cost of capital. However it is not always the case that this represents an overall loss to the public purse. For example the actual capital cost incurred by the private partner may be less than the equivalent project would have cost had it been procured by the public sector. Alternatively the private partner may be able to run the facility at lower cost. When assessing the impact of a deal it is essential that all relevant costs are assessed.

Political Environment

It is important that decisions to use innovative funding approaches in any particular case are taken for the right reasons. Only by ensuring that the dice are not loaded either for or against such approaches and that other valid options are not ignored is it possible to take an objective view of whether or not any particular funding approach is optimal in a particular case.

It is important that where innovative funding approaches are chosen as a way forward, any choice is made on objective grounds. Ideally there should be broad political acceptance and support for such approaches in order to create the right climate in which public and private sector can work together. However it is acknowledged that in practice this may be difficult to achieve given the current political arithmetic in Holyrood. Nonetheless funders and contractors will be reluctant to work in an environment where deals are scrutinised. Inevitably they will seek to mitigate such situations by charging a 'risk premium'. Politicisation of projects is undesirable and creates an unsuitable climate in which to do business. Politicisation of projects is not only a risk for the provider of funding - if there is ambiguity as to future arrangements it will be difficult for public servants to negotiate a good deal with the private sector.

It is essential to emphasise the paramount importance of accurate scoping of the requirements of the client – indeed this should apply to all major public investments, regardless of the method of implementation. Much greater attention needs to be placed upon:

- Planning and developing "business" requirements – not only to meet current needs but also how those needs might change in the future; their implications on the venture; and how to cope with this.
- The use of sensitivity analysis to build in provision for altered circumstances – not only from the public sector perspective but also full consideration of the private sector provider's perspective.

Above all, it is essential to ensure that the focus remains clearly on defining the requirements according to what is needed, on "why are we doing this?" Evidence from England suggests there have been serious problems e.g. with capacity of hospitals where scoping has been determined not by forecasts of patient flows/requirements but by "working backwards" from budgetary constraints. Conversely of course on occasion the desire to guarantee flexibility may, in some circumstances, lead to building in redundant capacity or features.

In terms of implementation of PFI projects, while performance penalties are necessary to ensure high standards of provision, too little attention is paid to encouraging innovative approaches (from either side) to introduce beneficial changes in the way things are done. There need to be clearer incentives on both sides to seek improvements over time to realise mutual benefits.

Practical Guidance

If it is decided to go forward with alternative methods of financing investment in the public sector it will be important to ensure that the commissioning public sector authorities possess adequate commercial awareness and knowledge "in-house". This is potentially something of a challenge for certain parts of the public sector in Scotland, given that experience of such schemes is not uniform across the sector and given the small size of some public sector bodies in Scotland (although it is acknowledged that relatively small size is not a barrier to innovation in this area and that some of the most innovative work has been done by smaller local authorities). Intelligent use of consultants and other advisors can provide the necessary level of guidance but effective knowledge-sharing by the public sector also has an important role to play in ensuring good practice is widely distributed across public sector organisations in Scotland. Considerable expertise exists in other parts of the UK and this should be used for the benefit of Scotland. It will be beneficial to draw on expertise from within the public sector elsewhere in the UK and build on experience in the Scottish public sector, developing expertise in managing such projects within Scottish public sector organisations, rather than regarding PFI as a way of simply cutting back on, or contracting out, project management.

In our view it is also important that innovation is not stifled by an unnecessarily inflexible approach. By continuing to promote a range of options the opportunity for further innovation will be encouraged.

Routine application of a single approach, by contrast, will tend to discourage new ideas to the disadvantage of society as a whole. All parties to such funding arrangements must be prepared to work flexibly to achieve continuous improvement.

Conclusion

To sum up, we believe that:

- PPP/PFI may have a place where it is clear that the additional efficiency of private sector management outweighs the additional costs of private sector financing and the profit element of contractors;

- While there are many positive experiences of PPP/PFI to date, concerns about the inflexibility of such solutions to adapt to changes in service requirements over time may well grow as such projects mature;

- Arguments over PFI, in particular, have been distorted by representing the way in which PFI enables unhelpful public finance practices to be avoided or circumvented (the rigid separation of capital and revenue budgets, the failure to ensure adequate maintenance budgets for publicly operated facilities are respected, the tendency of “traditional” public sector procurement to allow frequent changes of design and specification once contracts have been let) as advantages which are a product of PFI in itself. This is not necessarily the case;

- It is essential to weigh up the case for any PPP/PFI scheme in a way which disregards these arguments and the distorting impact of the concern to get capital projects off the public sector balance sheet. Too often in the past, PPP/PFI has been seen as the only alternative for achieving major public sector projects, which undermines real consideration of the benefits and disbenefits of going ahead on this basis and weakens the public sector’s negotiating hand;

- PPP/PFI requires a genuine partnership between all parties, which incentivises each of them to identify ways in which service improvements can be achieved;

- This partnership requires genuine expertise, ownership and involvement from the public sector partner: it should not be an excuse for cutting back on project management expertise and any move to increase the use of PFI in Scotland would require a concerted effort to enhance the skills base within the public sector;

- There must be a much clearer focus on the needs which any major project is seeking to meet, for much greater attention to the way in which such needs may change over time, and for greater flexibility to be built in to projects which are selected for a PPP/PFI approach.

We hope these initial thoughts are of use to the Committee. We are happy to provide any further input to the Committee’s consideration of this important issue that may be necessary.

Yours sincerely

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