The Chartered Institute of Public Finance & Accountancy

private finance initiative

Lessons Learned

We recently held a series of PFI Roundtable Discussions in collaboration with Trowers & Hamlins LLP. Finance managers from throughout the UK were invited to share their thoughts and experiences regarding the current programme, as well as putting forward their views on the initiative's future. Below is a summary of the key findings.

The future landscape for PFI

The foreseeable future will be shaped by public sector bodies continuing to face pressure to reduce expenditure in real terms. Experience to date clearly shows that savings can be delivered from PFI schemes.

Given the financial pressures facing the whole public sector, the government will continue to encourage all spending departments and other bodies (eg local authorities, NHS Trusts, etc) to deliver cost savings in operational PFI projects and to improve the cost efficiency of future PFI contracts.

To achieve efficiency savings from PFI contracts the public sector and the private sector need to work together to support long-term relationships with a view to identifying and delivering real cost reductions.

This is already reflected in the high number of private sector partners who have signed the voluntary Code of Conduct for Operational PFI/PPP schemes, which was first issued in June 2013. The list of public and private sector signatories to the Code has grown steadily since then.

Whilst due regard must be had for the contractual provisions that define PFI projects, all parties are beginning to recognise the national imperative to work together to deliver substantial, repeatable savings.

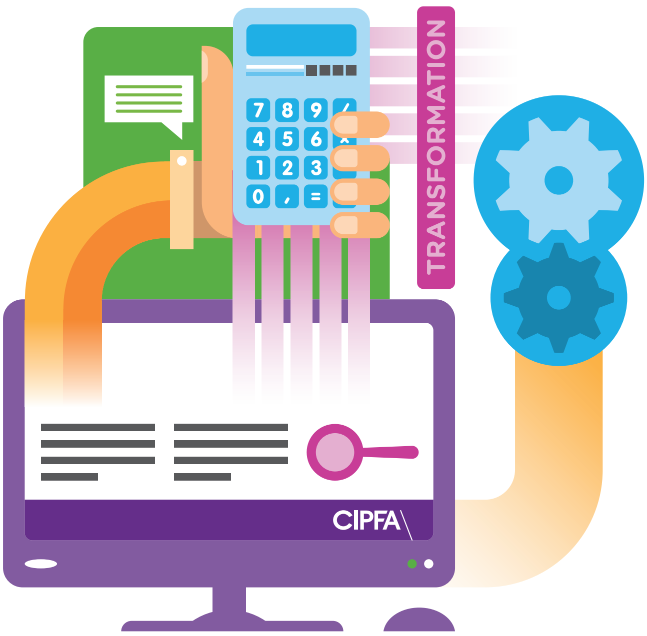

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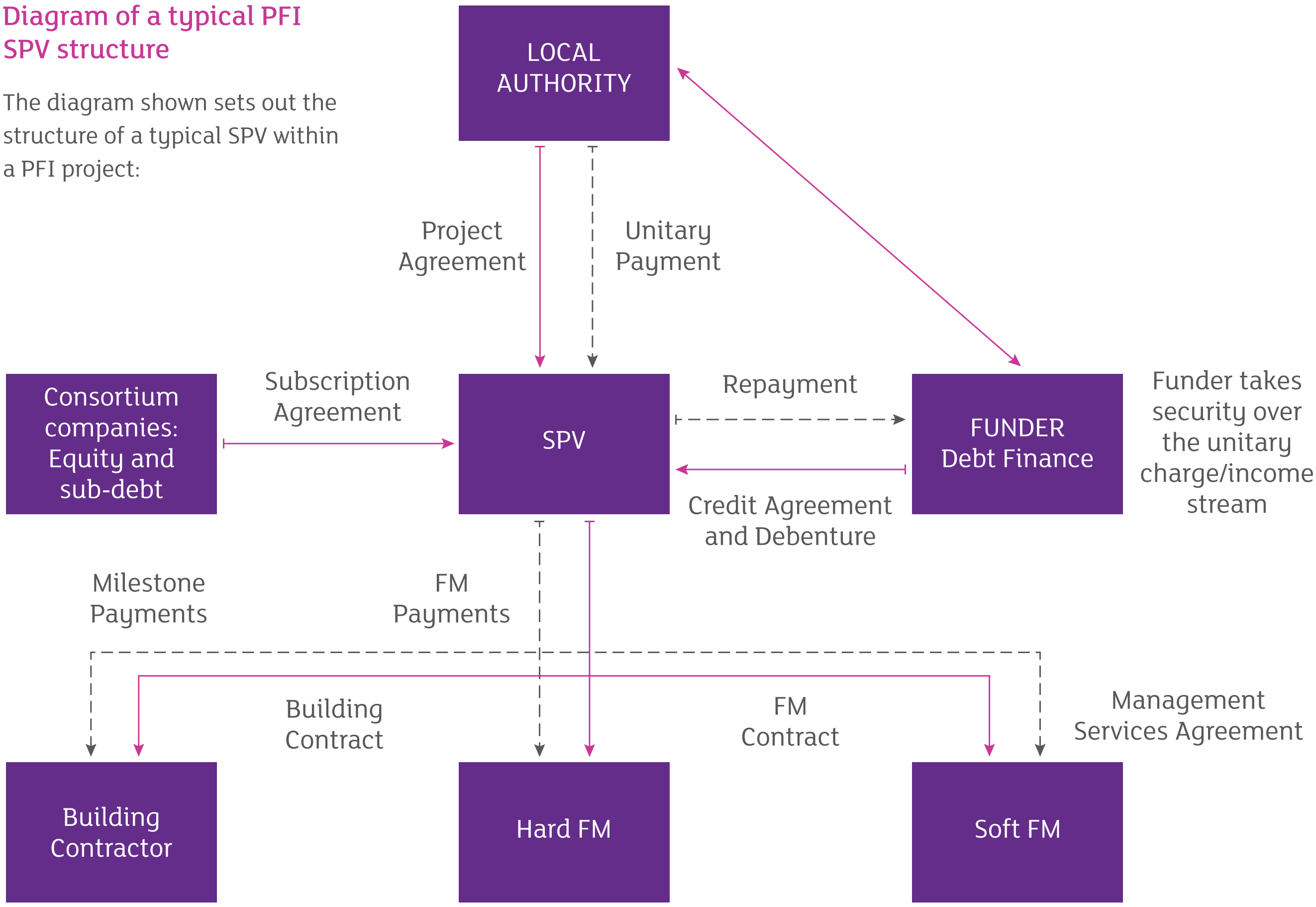
Diagram of a typical PFI SPV structure

The diagram shown sets out the structure of a typical SPV within a PFI project:



Key areas to consider for savings

The first step for a public body with operational PFI contracts is to carry out a contract savings review to ensure effective application and management of existing contract provisions. To ensure that any discussions with the private sector contractor generate maximum rewards, the public body should also review the project generally to ensure it meets its objectives and set clear outcomes for what it wants the PFI arrangement to deliver following review.

Following HM Treasury guidelines, CIPFA and Trowers & Hamlins have worked with clients across a range of sectors to successfully deliver savings by targeting the following areas:

Facilities management and services – review requirements

Reviewing the specification of soft services so that the public sector only pays for services that are needed and reduces the frequency of non-essential services where the original specification was higher than is now required or can be afforded. This can also involve a change in scope and quantity of services and a re-visiting of the entire payment mechanism.

SPV costs – minimise management charges

Examine SPV management charges and minimise SPV mark-up through the supply chain. Accelerate payment terms and timings to reduce SPV working capital requirements and optimising basis for variations.

Use of assets – optimise

Selling surplus assets and utilising third party income provisions and opportunities to save on or offset asset costs. Implementing flexible asset management to exploit facilities more intensively can also reduce waste and prompt greater returns. Mothballing of unused areas of serviced accommodation may also be considered.

Financing arrangements – optimise

Carry out a refinancing of project borrowings could result in significant long-term savings from shaving even a fraction of one per cent off the interest rate. Other changes that can be made include changing the loan payments to 1-month LIBOR swap, sharing of equity returns above a threshold, capital contributions, shares in gains on sale of equity, as well as considering the efficiency of current accounting and tax treatment.

Ensure risk transfer is cost effective

PFI projects transfer risks such as change in law, insurance costs, maintenance, service provision and lifecycle from the public sector to the private sector. The private sector prices for taking on these risks.

As PFI schemes have evolved, the consensus as to what risks are cost effective to transfer has changed. Public bodies should consider their appetite for taking back and managing such risk in exchange for a commensurate reduction in price.

Insurance provisions – optimise

Many PFI contracts acknowledge the varying cost of insurance over time and existing provisions should be varied and cost/gain share mechanisms in relation to insurance costs applied.

Further, existing insurances could be scaled back or may no longer be needed as part of the PFI project, so these could be stripped out with the reduction in premiums paid by the SPV being reflected in a reduction in the Unitary Charge.

Other negotiating points – consider as part of overall contract renegotiation

If a public body is embarking on a renegotiation of its PFI contract, wider possibilities for obtaining better value for money should also be considered. Extension to the term of the contract or changes to the operation of the payment mechanism could well result in savings from leveraging economies of scale. If there are grounds (eg Contractor Default) and/or a compelling financial case, the option of terminating the contract should not be overlooked.

Other – further issues identified as relevant to the specific contract under review

The extent to which savings will be available across operational PFI projects will depend upon the bespoke nature of the services being delivered under each contract, the degree of active management which has already been applied and the extent to which the specification exceeds requirements. In conducting any review, opportunities in addition to those described above may present themselves.

Managing the variation process

One key method for accessing real terms savings in operational PFI projects is to vary the terms of the PFI contract (to address some or all of the matters set out above). Realigning the contract with the changing requirements of the public body can make the operational project more cost effective.

An often-repeated criticism of PFI is the complexity involved in varying the contract terms after financial close. This is still the case even with the government's Code of Conduct, guidance and standard documents developed to assist the process.

However, with appropriate planning and strategies in place, it is possible for public bodies to drive the process forward to achieve their objectives. The stages through which public bodies should approach PFI cost saving are set out below:

Stage 1 – Options Appraisal

Public bodies should ensure that they have a good understanding of the existing contractual terms and are effectively managing the contract. For example, is the public body levying all of the deductions that it is entitled to and are there existing provisions such as insurance cost sharing, benchmarking or market-testing that could be utilised to secure "quick wins".

As part of effective project management, the public sector body should engage commercial and legal advisors (if the contract is being amended) and, where relevant, technical and financial advisors to assist the public body with understanding and validating underlying costs, financial concerns and payment mechanism implications. Advisors will also be able to set out any market and sector-specific changes that have occurred since signature of the original agreement that could benefit the relevant project.

It must also be borne in mind that a business case will need to be made that supports the changes envisaged that arise from the type of exercise described here. Such a business case will be required by the entity undertaking the review as well as other legitimately interested stakeholders, eg a spending department, funders, etc.

At this stage public bodies should also consider any procurement issues (noting the new provisions in relation to the variation of procured contracts under the Public Contracts Regulations 2015) as well as considering whether to consolidate changes that have already occurred such as historic notices of change.

Stage 2 – Agreeing Variation Strategy

Once an options appraisal has been undertaken, the key outcomes sought by the public sector should be set. The relevant contractual mechanisms to be used, such as a formal change notice, use of surveys, benchmarking, refinancing or insurance cost sharing can be identified.

If a renegotiated variation (outside of any existing contractual mechanisms) is required, the public body should evaluate whether there are any compensation sums to be paid to the Contractor (eg if any services are to be terminated), what principles should apply to negotiations (for example, "no better no worse" or using PF2 as a benchmark), whether there are any employee issues and the extent of any construction defects.

In practical terms this means carrying out the above preparatory work prior to engaging with the SPV, making sufficient resources available and clearing the project plan with a designated project manager.

It is also helpful to establish an empowered project management team and set out clear lines of communication for instructing advisors and conducting negotiations with the private sector party.

Regular internal meetings should be held to monitor key milestones and project plans, ensuring that relevant timeframes are being adhered to. Lastly, the document update methodology will need also need to be agreed.

Stage 3 – Legal, Technical and Financial Management

Prior to the Project Agreement mark-up, a commercial principles table and Deed of Variation should be prepared. The specifications should be updated to reflect any new service delineation and the performance mechanism and financial model should be reviewed. New interface arrangements and stakeholder engagements also need to be considered.

Stage 4 – Negotiation Process

A PFI contract has a finely balanced risk profile and contractual mechanism, integrating construction and service provisions into one contract through a deductions mechanism. This adds levels of complexity to varying PFI contractual provisions, insurance clauses, payment mechanisms and specifications because any change can have knock on effects.

Some obligations in relation to the project must remain with a particular party (and cannot be terminated) and there are likely to be new interface issues between subcontractors which need to be addressed (eg how the parties could affect each other's ability to perform their obligations).

Given these complexities, the public body must consider how to incentivise the private sector to engage with the variation. Although some PFI contracts have a change mechanism which provides for some level of engagement, the private sector often has little incentive to negotiate a variation.

The reason for this is that the variation could result in a different risk profile to the project as it stands and SPVs are reluctant to incur the cost of investing time in the variation process. Unless the private sector counterparty is receiving an increased return or some of the benefit, it could take the view that there is no benefit to being involved in the variation.

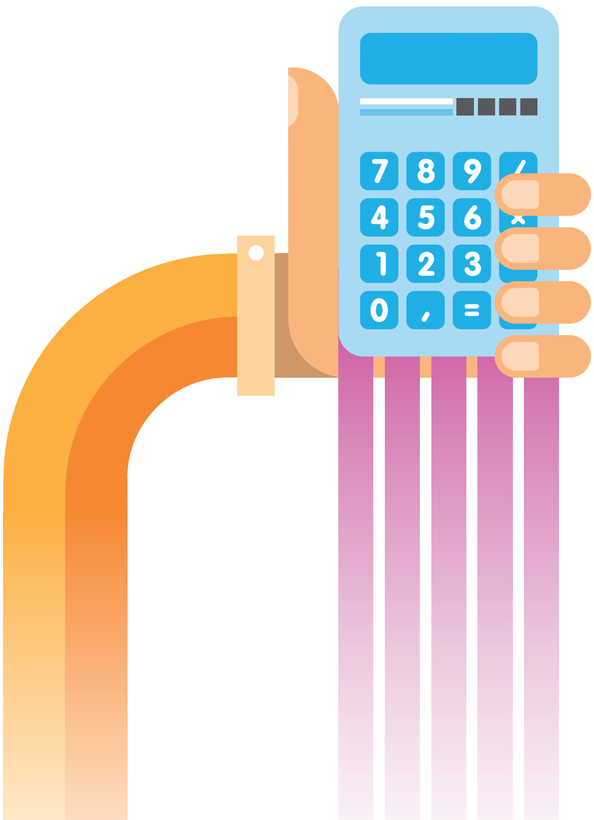
To bring the SPV to the table and achieve the variation it seeks, the public body should leverage any contractual mechanisms that it has. For example if there is a particular KPI that is giving rise to significant deductions, this could be used as a bargaining chip to encourage engagement. From our experiences, the relevant mechanisms vary from project to project. Once engaged, a cap on the costs that the public body will pay should encourage the SPV and its advisors to move swiftly in negotiations. At the same time it is important to avoid damaging the relationship with the private sector partner.

The PFI contract ties in all parties for the long term and so, regardless of the outcome of the negotiations, a working relationship must be maintained.

Stage 5 – Execution Stage

At the execution stage, the approval process for public sector and funders (syndicate issues) needs to be considered. The correct authorisations and conditions precedent will be required. Public bodies should bear in mind that it is not just the SPV consent which must be obtained but also lender consent, third party shareholders, FM sub-contractors, parent company guarantors and sometimes central government bodies.

The incentives of some of these parties can be even further removed than those of the SPV and so delays can arise at this stage. Due diligence of finance and sub-contract documents will need to be done to ensure relevant approvals have been obtained and contract variations have been properly flowed down. Once executed, there will be a mobilisation and bedding-in period.



Financial Implications

Typically the private sector partner will request that the public body bears the costs the SPV incurs in the negotiation of the variation. Lenders are also likely to ask the public sector to bear its advisor costs along with any arrangement or variation fees that they might charge.

As mentioned above, the public body should seek to agree caps on these fees to avoid costs spiralling and to encourage progress in the negotiations. However, a variation, particularly for the reduction of services provided under the PFI contract can result in the public body paying a significantly lower Unitary Charge. Savings therefore amass over the long-term. The trade-off for paying less could be the public body taking on more risk, such as the risk of carrying out the services itself.

In the context of a variation to reduce the services provided under the PFI contract, the public body will need to provide or procure an alternative method/source for provision of the services.

Contact us

If you would like further information about any of the above, please do not hesitate to contact us.

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