National Assembly for Wales -
Finance Committee

Inquiry into the use of Public Private Partnership Schemes

Evidence provided by KPMG LLP

KPMG LLP

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1 Introduction

1.1 Background

1.1.1 The National Assembly for Wales Finance Committee is calling for evidence for its inquiry into the use of Public-Private Partnerships (PPPs) (including Private Finance Initiative - PFI - schemes).

1.1.2 The Committee wishes to examine the ways in which private sector money can be used to promote public sector projects in Wales and has agreed the following terms of reference for the inquiry - to examine the scope for drawing on private finance for public sector projects with particular reference to:

a. The potential benefits, costs and risks that may be involved;

b. Any policy changes (whether to remove barriers or apply controls) that may be needed to realise the optimum outcome; and

c. Practical guidance to enable the public sector to strike the most advantageous arrangements within the agreed policy framework.

1.2 Purpose of this document

1.2.1 This document constitutes the written evidence of KPMG LLP to the Inquiry. In this document we have focused on a & c on the above Terms of Reference.

1.2.2 KPMG is one of the worlds' leading advisers on PPP/PFI with clients in more than 40 countries. We advise across diverse sectors including technology, energy, natural resources, transport, healthcare, education, social services and real estate.

2 The Potential Benefits, Costs and Risks of Public Private Partnerships

2.1 Overview

2.1.1 The involvement of the private sector is the delivery of public sector services and the creation of public sector assets can take a number of forms, including:

- Outsourcing of services previously carried out by the public sector (e.g. local government information technology back office services);
- The provision of new public sector services and assets not previously provided by the public sector (e.g. the London congestion charge schemes);
- Public Private Partnerships (PPP) for the delivery of services (e.g. the PACT partnership at DVLA)
- The creation, financing and operation of new assets under the Private Finance Initiative (PFI) (e.g. schools, hospitals, roads).

2.1.2 This paper focuses primarily on the last two forms of public- private partnerships.

2.2 PPP/PFI: Benefits

2.2.1 Research has shown that – along with the strong contractual frameworks – a PPP/PFI approach to public sector procurement has led to successful projects. The record of the completion of public assets on time has improved. For example, in 2003 the National Audit Office (NAO) established that 76% of PFI buildings were completed on time. This compared very favourably with the HM Treasury (1998; 1999) finding that the equivalent figure for traditionally procured buildings was 30%. The improvement can be largely credited to the strong financial incentive to achieve service commencement in PFI projects.

2.2.2 Cost overruns in public procurement have also reduced under PPP/PFI. This is because the transfer of construction cost risk in PFI projects has been extremely effective. HM Treasury (1998; 1999) found that a large number of public sector clients suffered from construction cost overruns when using traditional procurement. This has not been the case where PFI procurement has been used. NAO (2003) found that in a selection of cases the private sector had absorbed all cost overruns arising from construction related issues. If capital cost increases had been passed onto the public sector client, it was because the public sector client had required changes to the project after financial close.

2.2.3 The clients' relationship with the private sector has improved. In traditionally procured projects, the client's relationship especially with the contractor is widely acknowledged to be somewhat adversarial. NAO (2001) found that in PFI projects 72% of clients and 80% of private companies perceived their relationships with each other to be either very good or good. No equivalent study on traditional procurement exists. Some explain the emergence of such partnership by the incentives created by the long-term commitment that the contracting parties make to each other.

2.2.4 The predictability of future public sector expenditure on public services has increased. This is a major improvement in comparison to a context dominated by the use of traditional construction and operational service procurement. Public sector expenditure on, say, major maintenance was largely determined by the funds available through annual maintenance budgets. Anecdotal evidence suggests that these budgets tended to be highly volatile which, on occasions, resulted in sub-optimal maintenance.

2.2.5 The operational certainty of public asset-based services has improved. Performance related payment and project finance are key features of PPP/PFI procurement. They have created an incentive for the service provider to ensure operational certainty in order to avoid payment deductions. As a result, for example, a PFI hospital is likely to have more back-up electricity generation capacity than a traditionally procured hospital. Increased operational certainty is likely to decrease disruptions in the client's core service, provision over the PFI contract period and, thus, yield increased benefits. According to Partnerships UK (2006), 79% of projects have services delivered to agreed standards always or almost always.

2.2.6 The benefits of PPP/PFI arise largely from transferring the risk of delivery to the private sector and the involvement of private financing in overseeing the allocation of those risks. In other words, the rigorous due diligence and credit functions of a bank or a monoline insurer ensure that projects have an appropriately allocation or risks between the public and private sectors and that the risks transferred to the private sector flow down appropriately into the subcontracts.

2.3 PPP/PFI: Costs and Risks

2.3.1 A key argument against the use of PPP/PFI has been the use of private sector funding which is perceived to be more expensive than public sector financing. However, in comparing the cost of public and private sector finance, one view is to assume the higher cost of private finance to include a fee for managing project risk. It is then a judgement whether this fee is good value for outsourcing risk management or whether there are imperfections in the financial markets and the public sector could manage these risks more cost effectively than the private sector. On conventional wisdom, it is unlikely that the public sector would be able to outperform the private sector market in risk management provided that the project is within the comfort zone of the market.

2.3.2 A further argument against the use of private finance is that many infrastructure project are tied into very long contract lengths partly to allow private financiers to recover the cost of financing capital investment over a period that also allows public sector procuring authorities to repay the cost of any upfront private sector funding in manageable service charges on a year to year basis. This is particularly an issue where policy changes effect the original requirements for the assets (e.g. reconciling a policy focussed on community based healthcare with the need to refurbish or replace large general hospitals in very large contracts).

2.3.3 There is also perception or political risk associated with PPP/PFI. The refinancing gains enjoyed by contractors on early PPP/PFI projects were widely reported as well as the financial difficulties that unsuccessful contractors have found themselves in when projects have been unsuccessful. That said, standard HM Treasury Guidance for PFI contracts has closed many loopholes that existed on early deals and all contracts should include refinancing gain share mechanisms. Moreover, the financial difficulties that confront unsuccessful contractors also indicate that these contractors are taking genuine financial risk on asset and service delivery.

3 Getting the Best Out of Private Finance

3.1 Overview

As part of this submission we have not commented on the specific policies adopted by the Welsh Assembly Government in terms of the use of private finance though we recognise that in certain areas the policy has been to eschew the use of private finance altogether. In the section below we set out some practical steps that could be taken in Wales as part of a process of using private finance where is makes sense to do so, adopting the best of procurement practice seen elsewhere (including alternative models) while ensuring value for money for the taxpayer.

3.2 Using Alternative Models

The UK government introduced the Private Finance Initiative (PFI) in 1992 and there is now a considerable track record and embedded experience among public sector bodies and advisers about what has been successful and what has worked less well. Alternative models to the "standard" PFI approach have been seen in the UK and elsewhere and include:

- Not for Profit Distributing (NPDO) Model where a standard PPP/PFI contract could be used but where the private sector consortium (as opposed to the subcontractors making up the consortium) that contracts with the public sector Authority to build the asset does not take any profit from the project. Only senior and subordinated debt is provided - there is no private sector equity in the model. In effect, the model caps the return on the private sector funding but may dilute risk transfer. This approach has been successfully used in Scottish Schools Projects;
- Municipal bond financing – the Scottish Parliament is looking at use of public sector financing instruments similar to the municipal bond market in the United States. However details of how these instruments well be set up and what constraints will need to be relaxed have yet to be determined (e.g. in the United States such instruments are based on tax benefits which may not be available to devolved governments);
- Other charging models – some assets are suitable to allow recovery of capital investment costs directly from users. An example would be road construction whereby the costs of the asset investment are borne by the private sector but the investment is recovered though toll charges to users.

3.3 Value for Money

Delivering a good capital investment project is about more than the cost of finance. Funding is only one aspect. Cheap money is of little use if a project is poorly defined, does not deliver strategic objectives and overall project costs are allowed to spiral.

In our experience, projects deliver value for money when the following aspects have been met:

- Clear outcomes are set for the specific project;
- Individual projects sit within a coherent overall programme of investment;
- Projects and programmes are subject to strong challenge as they are developed eg Gateway Reviews or Key Stage Reviews;
- Commitment of the public and private parties is made once risks are well understood, clearly allocated and effectively managed;
- Value for money and affordability are kept under regular review as the project moves towards implementation;
- Strong project and programme management keep projects to time and budget;
- Contractual structures between the private and the public sector allocate risk to the party best able to bear that risk; and
- Parties are incentivised to meet clear outcomes.

4 Conclusion: one size does not fit all

4.1.1 There are many sources of funding available to the public sector in procuring capital investment projects. The funding method should be chosen depending on the overall risk profile of the project and value for money in each case, looking at not just the initial capital costs, but the lifecycle and operational costs.

4.1.2 The costs and benefits of third party funding should not be seen just in terms of the costs of private finance as compared to public funding. The costs of private financing should also take into account the added value of pre-commitment due diligence and ongoing project monitoring and management by funders, functions which the public sector does not necessarily have the resource and capability to carry out.

4.1.3 In general terms, PFI/PPP is not appropriate for smaller scale projects, but can bring real benefits in delivering successful projects on time and on budget.

4.1.4 The NPDO model is a helpful addition to the funding toolkit and should be monitored closely – particularly around ensuring that NPDOs are delivering as efficiently during the operational phase as PFI/PPP projects.

4.1.5 Wales has significant challenges ahead to grow its economy and improvement in infrastructure is vital to growth. Delivering the investment programme will have a part to play in rising to that challenge, as will ensuring that productivity in all sectors of the economy increases – particularly in the public sector which plays a large part in the Welsh economy.

4.1.6 A key issue to progress those plans to meet strategic outcomes. Wales will face competition in the supply side from the construction opportunities elsewhere – particularly the Olympics. Construction cost inflation is a real issue for the public sector in procuring these projects and unnecessary delay erodes value and affordability.