

Letter from the Editors

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The Canal of Languedoc and the Private Finance Initiative

“The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the experience to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain”. (*An Inquiry into the Nature and Causes of The Wealth of Nations*, by Adam Smith, book. V., chapter. 1., Part III, third edition 1784)

“The Private Finance Initiative (PFI) has become one of government’s main instruments for the delivery of high quality and cost effective public services. It presents those responsible for the provision of public services with the opportunity to procure those services, or the buildings and infrastructure within which to provide the services, while leaving the risks of asset and infrastructure ownership and maintenance with the private sector.” (*The Treasury Task Force, Introduction*, <http://www.treasury-projects-taskforce.gov.uk/intro/main.htm>)

Should the government design, build, finance, operate, and maintain a prison or can it achieve better value for money by procuring the prison services it requires from the private sector? In the United Kingdom the same question is being asked about the infrastructure and capital equipment required in the provision of education, health, defense, police, sanitation, and energy services. Transforming the public sector’s role from funding, owning, maintaining, and managing public facilities to an entity responsible for contracting with a private company or consortium for the current and future provision of a specified quantitative and qualitative level of services is the essence of the Private Finance Initiative in the United Kingdom.

Public authorities in the U.K. are now required to measure each capital project they plan to undertake in terms of its eligibility for the Private Finance Initiative. A project is suitable for the PFI if the government receives “value for money” when measured against the alternative of building, financing and operating the project itself. Value not only encompasses the return on funds but it must account for risks retained by the public sector and the risks shifted to the private sector, such as construction risk, performance risk, political risk, interest rate risk,

price risk and residual risk. As of December 1st, 1997 the U.S. Department of State placed the value of projects started under the United Kingdom’s PFI at \$8 billion.

Since the public sector can typically finance a project at a lower cost than a private company, the gains derived from having the private sector build, own and operate public facilities will generally be derived from innovative designs, efficiencies in the management and delivery of services, and the ability of the private sector to offer its employees an incentive scheme that induces them to deliver the project sponsor value for money.

“In several different parts of Europe the toll or lock-duty upon a canal is the property of private persons, whose private interest obliges them to keep up the canal. If it is not kept in tolerable order, the navigation necessarily ceases altogether, and along with it the whole profit which they can make by the tolls. If those tolls were put under the management of commissioners, who had themselves no interest in them, they might be less attentive to the maintenance of the works which produced them. The canal of Languedoc cost the king of France and the province upwards of thirteen millions of livres, which (at twenty-eight livres the mark of silver, the value of French money in the end of the last century) amounted to upwards of nine hundred thousand pounds sterling. When the great work was finished, the most likely method, it was found, of keeping it in constant repair was to make a present of the tolls to Riquet the engineer, who planned and conducted the work. These tools constitute at present a very large estate to the different branches of the family of the gentleman, who have, therefore, a great interest to keep the work in constant repair. But had those tolls been put under the management of commissioners, who had no such interest, they might perhaps have been dissipated in ornamental and unnecessary expences, while the most essential parts of the work were allowed to go to ruin”. (*An Inquiry into the Nature and Causes of The Wealth of Nations*, by Adam Smith, book. V., chapter. 1., Part III, third edition 1784)

Her Majesty’s Prison Services has procured new prison services at Bridgend and Fazakerley from the private sector. The PFI contracts require the consortia that won each contract, Securicor with Costain won the Bridgend contract and Group 4 with Tarmac won the Fazakerley, to build, operate and maintain the prisons for 25 years. The National Audit Office (NAO) estimated that two

contracts would cost GBP 513 million. The NAO translated this cost into an estimated savings of 10% per year relative to the alternative of the public sector undertaking the design, funding, construction and operation of the prisons.

Consortia that win PFI concessions are frequently structured as special purpose companies (SPC) whose sole activity is funding and fulfilling the terms of the PFI contract. A benefit of the SPC structure is that it offers financiers the ability of structuring a financial package around the performance of a specific well defined project. The long term nature of most PFI contracts makes them well suited for funding schemes that divide and allocate project cash flows along the time dimension. When the winning design divides the use of a project between services to the public sector sponsor and residual services offered in the market, the SPC can also separate the secure government portion of the contract from the riskier payments tied to selling the residual output and pass the lower capital costs associated with public revenue stream back to the public authority. Project cash flows can also be divided along the credit dimension, creating senior and subordinate interests. The consortium may fund the initial stages of the project from its balance sheet with a view to a future securitization. The option of refinancing via the securities markets, enables the consortium to use short term credit more aggressively to win PFI contracts. Of course there are risks with this strategy. The exit may be blocked or crowded when the consortium is ready to refinance its PFI contracts. The sponsor will want to assure that the consortium financial position does not collapse if the securitization option becomes uneconomical.

Annington Homes, the group owned by Nomura, Black Rock Capital and the Electra Fleming Fund purchased 55,000 housing units from the Ministry of Defense (MoD) in November 1996 via a Private Finance Initiative tender. Annington homes refinanced its portfolio of MoD housing via two separate securitization transactions: Annington Finance No. 1 (10/96) and Annington Finance No. 4 (12/97). Annington Finance No. 1, a three tranche deal, is collateralized by the MoD guaranteed rental stream associated with the acquired portfolio of housing. Annington No. 4, a three tranche transaction, is supported by the non-guaranteed portion of the rental stream and proceeds from dispositions of homes.

Securing the best overall bid requires a competitive process with clear rules and strict time tables. Formal invitations to expressions of interest in PFI projects are announced in the Official Journal of the European Community. Respondents to the OJEC solicitations are screened and ultimately short listed before tenders are invited. We have included excerpts from two invitations that were recently announced in the OJEC.

1. Publication date, 4/4/1998: "Expressions of interest are sought from suitable experienced organizations (or consortia) to design, build, finance and own a new town centre clinic to be built under the UK Government's Private Finance Initiative. . . . Awarding Authority: Guild Community Healthcare NHS Trust. . . . The Trust currently owns and occupies a town centre site in UK-Preston, Lancashire, providing a range of community-based clinic services. . . . Initial advice is that the current open market value of the freehold interest of the site to be in the order of 250,000 GBP. The Trust is interested in seeking a partner to develop the site by demolishing the existing facility and, when redeveloped, the trust would require to lease back the ground floor providing new improved clinic facilities. Informal approaches to the local planning authority have indicated that a new development might be considered up to a maximum of 5 stories, thus providing opportunities to the developer."

2. Publication date, 4/3/98: "Provision of a new 900-pupil secondary school in Leyton (east UK -London) to be designed, financed, built and operated by the contractor. Operation will include facilities management and other non-teaching services. Estimated construction costs, excluding VAT, fees and moveable equipment: 10,000,000 GBP, plus facilities management and other services. Estimated net present value over contract period in the region of 25 years: 20,000,000 GBP."

The ideas underlying the Private Finance Initiative are being applied beyond the shores of Great Britain. We look forward to publishing papers that examine how public benefits of public/private partnerships and joint ventures should be properly valued and how contracts between the public and private sectors should be written so as to minimize principal-agent conflicts. How can both sides of PFI contracts use the theory of real options more accurately to value concessions?

We thank the Advisory Board for their support and the authors of this issue for giving us the opportunity to publish their research and analysis.

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