

An introduction to Private Finance Initiatives (PFIs)

PFIs are an approach the Government sometimes uses to procure construction projects and other services. This document explains some of their characteristics.

What are PFIs?

When the Government wants to buy something (usually a construction project such as a school, or a hospital) it can raise the funds itself, hire the designer and contractors, and then undertake the work. Alternatively it can draw up an output specification for what it wants and enter into a Private Finance Initiative (PFI) where the design, finance, and construction are all provided (in some cases it may be a subset of the three) by a private consortium.

Under a PFI the private consortium typically undertakes to maintain the project for fifteen to thirty years after construction. This can for example involve servicing the building and providing catering. The consortium is paid back in predefined instalments, conditional on performance over the lifetime of the contract. On expiry of the contract, ownership of the project's assets normally reverts back to the public sector.

Although most PFIs are for new construction work, they can also be used for refurbishments and service provision. PFIs are a form of Public Private Partnership (PPP), which is a general term for collaboration between the public and private sectors.

When were they introduced and how many of them are there?

PFIs were introduced by the Conservatives in 1992, however their use only really took off after the 1997 election of the Labour Government. Although the role of PFIs has expanded, the majority of public investment (over 85% in 2003) is still carried out by traditional means of procurement.

Projects procured under PFIs have included: hospitals, offices, schools, prisons, housing and roads. There are currently 677 PFI projects in the UK and a database of existing projects is available at the Partnerships UK website (<http://www.partnershipsuk.org.uk>), which gives details of the individual projects around the country.

How are they used?

PFIs involve extensive risk transfer to the private sector and accordingly greater cost certainty for the Government. In order to ensure this, the project is tightly specified in the contract, defining who bears which risk. The private sector will not want to bear risk without some form of compensation, so it's important that the risks are transferred to the party that is best placed to bear and manage them efficiently. For example, typically the consortium will have to meet any cost overruns that arise in the normal course of work, but if costs rise as a result of the Government changing its mind on the design it wants, then the public sector would probably have to foot the bill.

The risk transfer and long time horizon of most PFI contracts means that the procurement process is often more involved than traditional approaches and that the contracts are less flexible. As a result PFIs are not typically used for smaller projects, where the effort involved in procurement would be disproportionate to the project's size. IT projects can also pose challenges as the fast pace of change in the sector means that it is hard to write long-term contracts. However long-term contracts also have benefits, as given that the PFI consortium has to bear the maintenance costs, it has an incentive to design an efficient project to minimise them.

PFI procurement involves consortia bidding for PFI projects through an extended bidding process. Consortia will typically include a major construction company, a source of finance and a facilities management contractor. It is hoped that by integrating the design, finance, construction and maintenance parts of the project in one package efficiencies can be achieved.

In order for a project to be approved as a PFI, the procuring party (often a Local Authority or Health Trust) has to undertake an assessment of whether the project constitutes value for money once the risk transfer to the private sector is taken into account. Details of the assessment procedure can be found at the Treasury website (<http://www.hmt.gov.uk>). The National Audit Office (NAO) has the primary role in scrutinising this process and produces reports on selected projects. These may be found on the NAO website (<http://www.nao.org.uk>).

There is international interest in the use of PFIs and as the approach has been developed in the UK, a base of experience has been built up, which the DTI's UK Trade and Investment (UKTI) is involved in promoting abroad.

Industry Economics and Statistics Directorate (IES),
<http://www.dti.gov.uk/construction/stats/procurement.htm>
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