MANAGING TO MEET PFI OBJECTIVES

INVOLVEMENT IN THE PFI FIELD REQUIRES AN UNUSUAL BLEND OF SKILLS. **TONY HAZELL** OF CORLA LIMITED REVEALS JUST WHAT IT TAKES TO MANAGE A PFI PROJECT EFFECTIVELY.

When the Private Finance Initiative (PFI) first came on the scene in the early 1990s it was immediately clear that a great deal of work had to be done before what, in essence, is a relatively simple concept could be made to work in practice. The critics (and they were around then as well as today) rightly pointed out that no private sector entity could borrow as cheaply as the government of the day. How, then, could PFI transactions ever pass the conflicting tests of value for money and risk transfer that lay at the cornerstone of the whole concept?

The answers then, as well as now, lie in the evaluation of the transaction as a whole and in quantifying the value of the total risk being transferred from the public sector to the private. At this point it is easy for the sceptic to observe that the exercise of attaching a monetary value to such risks opens the floodgates for the unscrupulous private sector bidder to massage the figures. However, it is important to understand that before any PFI contract is signed, it is subjected to intense, objective scrutiny by a highly skilled group of professionals, whose objective is to ensure that all relevant tests are met. These 'relevant tests' include assessing:

- the adequacy of the amount of risk transferred (this will drive the essential off-balance sheet treatment without which the deal will not be acceptable);
- the affordability of the proposed transaction;
- The suitability of the physical part of the asset being created, where appropriate; and
- the adequacy of the value for money being offered.

Readers will appreciate that a PFI transaction is a complex one that also has to be evaluated component by component, where each has to make a material contribution towards the above criteria. The finance input must therefore bring positive support for the overall transaction, as well as in its own right.

From the earliest days, a number of funding structures have been put on the table and immense effort has been expended by all involved to produce the steady stream of deals that we see today. All the funders (senior debt, subordinated debt, other risk capital) have developed a very clear understanding of how they expect the deals to work once they have been signed, and there is a good argument that says that this is when the real work of a PFI project begins.

THE KEY TO SUCCESS. The successful administration of these contracts requires an unusual blend of skills, ranging from accountancy to construction management, from corporate finance to all other aspects of contract monitoring. The most important attribute is to be able to look into the future as far as possible to head off trouble before it arrives and there is a very good reason for this. The risk capital involved in all of these deals is a relatively small proportion of its overall capital cost – usually 10% or so. A moment's reflection will show that this has to be the case, since the twin dictates of value for money and affordability will demand that this slice of debt is kept to a minimum. Risk capital, after all, costs money.

As a result, the special purpose vehicles (SPVs) that lie at the heart of these projects are very thinly capitalised. Therefore, they are not geared to take undue amounts of risk in their own right. This, in turn, drives a contract structure, where most risks are passed through to organisations that are better able to manage such risks. Despite this objective of passing risk on to those best able to manage and take it, there will always be some residual risk left with this thinly capitalised SPV. Prescient SPV management is therefore not just a desirable, it is absolutely essential.

The successful delivery of the very PFI projects that will provide (in large measure) the future infrastructure of the UK relies on expert management of the contract throughout its entire life. So each of the major risks transferred from the public sector to the private sector has to be proactively managed in such a way as to minimise the chances of their occurring and to reduce their impact should they become problematic. It is worth looking at some of the major risks involved in a typical PFI project:

- **Construction.** The physical asset (where one is involved) must be built to time, cost and clearly stated quality. Any failure in any of these areas will be borne by the builder and therefore be underpinned by his balance sheet and any additional credit supports, such as performance bonds and the like.

'IT IS ONCE THE FUNDING DEALS HAVE BEEN SIGNED THAT THE REAL WORK BEGINS'

- **Service delivery.** At the heart of all PFI projects is the provision of a serviced asset. The services involved will vary from project to project, but will typically include so-called hard and soft facilities management (FM), as well as the effective administration of the project throughout its entire life. The risks transferred here will include pricing (sometimes for up to 30 or more years), performance risk and the entire basket of risks that relate to the transfer of employment (from the public sector to the private sector).

- **Life cycle.** Each PFI project signed to date has been based upon the need for the serviced asset involved (be it a hospital, a road or a computer system) being maintained in accordance with some very carefully defined criteria such that it retains a degree of functionality at the end of the project similar to that at the very beginning. Therefore, the costs and timing of all necessary refurbishment, replacement (or so-called technological refreshment in the case of IT and other high-tech projects) falls firmly on the private sector. The overall objective is that, at the end of the contract, the public sector has a series of options open to it. It may typically either: opt to renew the deal with its PFI partner for a further, defined period; take the project back into its own administration; or walk away. There are other options, but these are the three main high level ones. In either of the first two options, the public sector must have an asset capable of allowing it to deliver its services to the public as originally defined for these options to be real. Therefore, the life cycle risk is a substantial one that requires intelligent and active management throughout.

- **Finance.** While clearly the capital cost of the PFI project must be raised in the most cost-efficient manner possible, it is also essential to recognise that there are significant risks that must be taken by the project's funders. These relate not only to the successful delivery of the project itself, but also to inflation throughout. For the overall deal to receive the necessary approvals, the SPV at the heart of the private sector offering must receive its regular recompense in the form of a unitary payment which, subject only to changes in volumes, poor performance or agreed changes in quality, will vary in line with inflation throughout the tenor of the deal. Since the cost of finance makes up a significant proportion of the costs being met, the funders too have to accept that their receipts will vary in line with inflation. While this may be a comfortable equation in times of modest and predictable inflation, a moment's reflection will show that periods of either hyper-inflation, or even of deflation, will introduce severe stresses to a business model cast in today's benign inflationary environment. While inflation itself cannot be managed at the SPV level, its effects must be in order to safeguard the project itself, and the interests of the stakeholders in the project.

Having illustrated the need for expert management of the SPVs at the heart of PFI projects, it is worth looking at the two most obvious models for achieving this (there are other models but it is not the objective of this article to describe and debate all possible management computations).

THE DIRECT EMPLOYMENT MANAGEMENT MODEL. In many of the early PFI projects, the stakeholders resolved to appoint their own SPV managers, either as direct employees of the SPV itself or by providing suitably skilled individuals on secondment from their own ranks. This has clear advantages, in that a senior funder can readily review and quickly get comfortable with such a resilient management model.

THE OUTSOURCED MANAGEMENT MODEL. Many SPV sponsors have come to believe of late that an independent, outsourced management model can bring greater benefits to the project. I do not propose to debate the strengths and weaknesses of each separately, since often one is the corollary of the other. The reason companies such as CorLa have enjoyed such a significant take-up in their offering lies in the following attributes:

- **Independence**. From any one of the project sponsors. Such independence can readily overcomes suspicions of partiality that might otherwise arise in cases where senior staff members are seconded from one or more of the project sponsors;
- **Skills.** The broad range of skills to be found in an independent, expert management house ensures that the changing needs of the project can more easily be resourced from such a flexible skill base. A specific example here relates to the periodic need for market testing of soft FM inputs to the project. Frequently, such testing is required on a five-yearly basis and it is economically pointless to suggest that an SPV retains these skills throughout.
- **Currency of technical knowledge.** This attribute applies equally to traditional technical skills as well as to the increasing plethora of technical financial issues that are dealt with at the SPV level. These financial skills range from issues of accounting treatment to current knowledge of taxation issues and they are continually changing.
- **Single-point accountability.** An expert, independent management house will have a contract with the SPV and this will clearly state what duties are required to be performed and what continuity is required (usually at the senior levels of input to the management process). Should issues of poor performance arise, the SPV has clearly stated remedies it may pursue without having to call in expensive employment lawyers.
- **A strong springboard for a well-priced sale of the investment.** A PFI project that enjoys independent management will be well-placed to trade such investments. The alternative models of a management service being provided by one of the project sponsors renders the investment more difficult to extricate from its parent. Similarly, there will be no track record of independent management and, as a result, the potential investor cannot guarantee that he or she will secure the returns on the project the vendors claim for it.

I hope I have given readers an insight into the need for active management of these complex, highly structured deals. I have not been in any way exhaustive in my analysis but I have attempted to deliver an even-handed analysis of the way forward.

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