

# A

## ANNEX 7.5 PRIVATE FINANCE INITIATIVE

**Private Finance Initiative (PFI) deals offer public sector organisations a structured way of contracting with a supplier to construct a facility and then purchase associated services of a specified quality over a sustained period. Because the private sector contractor puts its own funds at risk, it has powerful incentives to deliver to time and cost, and can thus offer value for money. PFI procurement is a flexible, versatile and often effective technique. But it is not appropriate for every project.**

**A.7.5.1** PFI is a method of procuring capital infrastructure, although it is not suited to all types of procurement. But used effectively, it can offer a number of strengths in delivering public infrastructure (see box A.7.5A). These stem from:

- sharing risk in delivering public projects within a structure in which the private sector contractor puts its own capital at risk;
- incentivising contractors through contractual penalties and bonuses, reinforced by the due diligence requirements imposed by the lenders financing them.

### **box A.7.5A strengths of PFI**

- the desired service standards are maintained
- new services are more likely to start on time
- projects are more likely to be completed on budget
- contractors are motivated to deliver the required service over the whole life of the asset
- transfer of risk to the party best placed to manage it

**A.7.5.2** PFI does not suit every project. It works best where:

- the structure of the project allows the public sector to define its needs after construction as service outputs that can be adequately contracted for in a way that ensures an effective and accountable delivery of long-term public services;
- there is experience (or reasonable expectation) of PFI offering better value for money for the public sector compared with other forms of procurement (see annex 4.6). For PFI contracts in the public sector there is a standardised form of VFM analysis;
- PFI projects should not be at the expense of staff terms and conditions. This is covered by the standard PFI contract (see paragraph A.7.5.6)

**A.7.5.3** Conversely, PFI is not usually suitable for:

- individual projects too small to justify the transaction costs; or
- large innovative IT projects, since it is rarely practical to specify the requirements sufficiently firmly in advance.

**A.7.5.4** The main procurement principles continue to apply when developing PFI deals. It is important that the output to be achieved is clearly specified rather than the method to be used in carrying out the contract, so that the supplier can innovate and manage risk effectively. However, it is sensible to clarify key areas of design early on, to prevent false starts and later misunderstandings.

**A.7.5.5** Using standard forms of contract can aid the negotiation process, giving confidence to both parties and helping avoid mistakes. For public sector PFI contracts, the Treasury has produced a standard set of terms and conditions known as the *Standardisation of PFI contracts*. ([www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_standardised\\_contracts.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_standardised_contracts.cfm)) Any departure from these must be approved by the Treasury.

**A.7.5.6** The use of such contracts does not, however, suggest that PFI deals can be entered into unthinkingly. Public sector organisations should strive to be intelligent customers, providing incentives to stimulate enough competition to achieve good value in procurement costs. Public sector organisations need to be conscious that their own reputations may be at risk when PFI contracts are carried out.

**A.7.5.7** Once a major asset has been constructed, it may be possible for the private sector partner to refinance the project more cheaply. The contract should specify how the financial benefit should be shared with the public sector purchaser. The Treasury has a standard refinancing protocol to achieve this.

**A.7.5.8** Further information including the standard PFI contract can be found on the Treasury Website [www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_index.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_index.cfm)).