ECONOMISTS' OUTLOOK

PFI – What Problems Lie Ahead?

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Philip Davidson (Partner) and Neill Morgan (Senior Manager) from KPMG's Restructuring team have recently concluded an assignment advising a lender group to a complex PFI deal. After two and a half years of analysis and negotiation, a way forward was finally agreed, to the satisfaction of the lenders, the government and the contractor. In this article, Neill draws on recent experience, identifies the current issues in the PFI market place and speculates on the likelihood of future problems with PFI deals.

Background

The Private Finance Initiative ('PFI') was set up by the Conservative government in 1992. Its objectives were to bring private sector skills and efficiencies to improve service delivery in the public sector; to allow some risk to be transferred to the private sector; and to bring in private capital to the public sector.

Under a PFI scheme, a capital project, such as a school or hospital, is designed, built, financed and operated by a private sector consortium, under a contract that typically lasts for 30 years. The consortium is paid a unitary fee from public money when the capital project is completed and put into operation. If the consortium misses performance targets in the operating phase, it is paid less.

PFI was slow to start but has been very widely used since the Labour Party came to government in 1997. PFI covers a wide variety of sectors including transport, health, defence, schools and prisons. It is estimated that PFI contracts worth c.GBP 42 billion have been signed. In recent years the PFI has accounted for 9% of public spending annually.

Key players in the sector include many large and listed construction and support services groups such as WS Atkins, Balfour Beatty, John Laing, Mowlem, Sir Robert McAlpine and Serco. Financial institutions active in the sector include Barclays, Royal Bank of Scotland, Deutsche Bank, HBOS and Lloyds TSB. A significant number of advisers have large and strong PFI focussed teams.

PFI is not exclusive to the UK. PFI or public private partnerships exist in many other countries (for example Australia, Singapore, France, Germany and Chile). However, each country has adapted the model to its own particular circumstances. France has supported its transport infrastructure over many years and does not face the same issues as the UK has, for instance with the London Underground (the biggest single PFI project in the UK, worth GBP 15.5 billion over 30 years).

Problem PFI deals

Many PFI deals have faced problems, including a schools project in Huddersfield and West Yorkshire, Croydon Tramlink (and other tram ventures in Sheffield, Manchester, Nottingham and the West Midlands), Dudley NHS Hospital, Ballast Wiltshire's three schools PFI projects in Tower Hamlets, Dudley and East Lothian; and the Skye Toll Bridge. Other examples of stressed or distressed PFI situations include Jarvis selling out of its PFI portfolio as it restructured its business and Amey's problems with Croydon Tramlink (amongst other corporate problems) before it was taken over by Ferrovial in 2003.

Some companies undoubtedly overstretched themselves. Amey now consider that they bid for too many PFI contracts. It is possible that Jarvis acted similarly. However, the main reason for these problems was the public and private sector experimenting with the level of risk the other could bear. Over the typical PFI lifecycle of 25–30 years these issues can still be categorized as 'early stage' problems This painful process is now behind participants in the market and lessons have been learned.

For example, Croydon Tramlink was deemed to be a transport success, with considerable success in reducing the number of car journeys in its area. Financially, the Special Purpose Vehicle ('SPV') was in serious difficulty. It was reported that the SPV had only seven weeks of cash remaining and a rescue refinancing was necessary. The main reason for this was that the viability of the project was heavily dependent on receipts from passengers. Passenger numbers were 80% of projected levels and the shortfall led to a GBP 10 million operating loss in one year alone.

So what was the response to avoid similar events occurring on subsequent city tram deals?

PFI bid teams put forward two options: either to increase significantly the price of their bids; or to decide not to take on passenger risk and ensure that they were responsible only for the financing, construction and maintenance of the trams. The second option was favoured and so local councils paid an availability fee for running the system, so lessening the dependence on fare revenue.

Our experience

The particular assignment KPMG advised on related to a one-off asset that was highly specialized in nature. The combination of the specialized nature of the project, and that the deal was written fairly early on in the life of PFI (and so the PFI SPV took on the risk of delivering various output specifications that it was subsequently found were not capable of being delivered), meant that the project soon became troubled.

These elements are of less relevance in the future as:

– It is unlikely that similarly specialized assets will be sourced via PFI;

– The experience of corporates and financial institutions in PFI generally is much greater and so the chances of a similar deal being proposed, bid for and awarded using similar contractual arrangements are remote.

Current status of the market

The market place has developed and matured as a result of the experience gained by all parties. It is better understood by all its participants.

The practice of refinancing equity stakes to lock in gains made on successful deals has diminished now that corporates with exposure to PFI are better rated by the market. For instance, Carillion plc has, as at March 2005, made equity investments of GBP 29 million in 18 PFI schemes. These are now valued conservatively at GBP 83 million.

Similar signs of progress in this area can be seen in the changing stance of the relevant public body on this issue. Refinancings were commonplace in the early years of PFI and almost all of the profit from the refinancing flowed to the equity investor. However, many PFI contracts now contain clauses saying that if successful refinancing of equity stakes is undertaken, the profit on refinancing will be shared equally with the relevant public body.

Other improvements include the amendment to procurement guidelines for information technology ('IT') PFI contracts to exclude the need for external funding. As IT systems are put in place, the equivalent of 'stage payments' on a building contract are being paid. This is in contrast to the original 'Construction Phase' (where external funding is typically drawn down to fund the project) and 'Operating Phase' (where the public body pays its unitary fee for the successful provision of the service). One of the benefits of this change is that there is less risk of distress in a project caused by its financial structure.

Participants in the PFI market are now very much playing to their strengths rather than attempting to do everything. Some corporates such as Jarvis have left the market. Laing has reinvented itself as a manager of PFI projects, but no longer acts as a construction company in PFI assignments. Some financial institutions have exited from the market place as a result of getting it wrong in the early stages of market development.

But despite PFI developing into a more stable and better understood market place, some risks still remain.

– *New entrants to the market place.* While there are barriers to entry in terms of skills and investment required to bid for projects, there are corporates and financial institutions who want to penetrate the market place to take a share of the rewards available. In February 2005, Alliance and Leicester announced that it would be breaking into the PFI market. On the corporate side, Hochtief took over Jarvis' PFI bid team of 12 in December 2004 and are looking to enter the UK market after successfully operating in the German and South American PFI markets.

– *Different applications for PFI.* There has been a long and tortuous road in getting PFI into social housing projects. Leeds Council has signed a PFI deal in March 2005, some six years after the project was first put forward. This brings the number of councils who have signed PFI deals for social housing to four. Given that these have been difficult to get off the ground as a result of their sensitivities it may be that these areas will prove problematical either to the tenants or the councils.

– *Risks that may come out later in existing PFI contracts* such as asset renewal risk As the PFI SPV prepares to hand back the capital project to the public body, it has to ensure that the assets are in suitable condition so that they will last some time into the future. An SPV has therefore to spend money renewing the assets to a pre-determined standard. Assumptions in this area are significant in bidding for a concession, but are yet to be fully tested because they are backended in the life of the concession and we have not reached that stage yet.

Conclusion and future

Drawing together the lessons learnt from our experience, the analysis behind other failures and the

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current and potential issues in the market place, what are the likely instances of distress in PFI projects going forwards?

We consider that there is a likely scenario where troubled PFI projects or companies need restructuring advice. The scenario is likely to arise from a combination, in whole or part, of the following factors:

- The length of PFI concessions – we have no experience, yet, of some of the backended risks in PFI.
- Corporates that have PFI as part of their business and have financial or operating problems caused by other parts of their business. Solutions might require the sale or renegotiation of their PFI contracts.
- New entrants to the market (whether corporates or financial institutions) might not have the skills or experience of existing players and may take on higher risk projects or projects that they do not have the skills to execute. This could lead to problems on specific deals.
- Similarly the use of PFI in new types of projects may require a learning curve that other areas have already been through.

However, given that the experience amassed since PFI was introduced has lead to a more stable market place, the volume of problem PFI deals is likely to be low and what work there is will be likely to come at intervals over many years. PFI is not a sector likely to face a rush of problem deals in a narrow timeframe.

Nevertheless, when problem PFI deals become visible, they are likely to be interesting and require specialist skills. This is due to the (at least) tri-partite nature of negotiations between the PFI SPV (and its shareholders), funders and government customer. In deals which attract political focus, another layer of complexity is added.

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