Sum of all its parts

20/12/2004

Last month an ACCA sponsored research report entitled, "Evaluating the operation of PFI in roads and hospitals" sent ripples of indignation through the UK PFI market. The report - undertaken by Pam Edwards, Jean Shaoul, Anne Stafford and Lorna Arblaster of Manchester University - makes its intentions palpably clear: In short, PFI does not pass the accountability test.

There is a whiff of ideology - nowadays seldom encountered upon the political landscape - about the report. By way of conclusion, the report succinctly states, "...the chief beneficiaries are the providers of finance and some of, though not necessarily all, the private sector service providers, leading to a redistribution not from the rich to the poor but from the mass of the population to the financial elite".

Understandably, some PFI financiers are shocked by the inflammatory nature of the report. "I'm stunned. It's beyond me why they would want to publish something like this now. It's an extraordinary conclusion to make," says one London-based PFI banker.

Others have taken the report in their stride. "The report didn't surprise me: that some areas of criticism will come from those who are philosophically against PFI. I think there will always be a tension between those who don't support PFI and those who live it day-by-day," says Bruce White, partner at Linklaters in London.

But ideology or not - does the report have a point or has it completely missed the mark? After all, this is not the first time that the UK PFI market has been accused of profiteering. The sharing of benefits from refinancing between public and private sector, now standard practise, was spawned by accusations of excessive profits. And last year a UK government report concluded, albeit without certainty, that the PFI equity market is also excessively profitable.

The reality is that UK PFI debt pricing is some of the cheapest in Europe, with many banks forced to take equity stakes on smaller deals just to top up profits from equity sales once the projects are up and running.

A value for money argument

ACCA is playing down the report's provocative conclusions. According to Andy Wynne, head of public sector issues at the ACCA (Association of Chartered and Certified Accountants): "The aim of the research is to look at a few cases at the operational phase; and to seek early indications of whether Value for Money (VFM) is being achieved."

He adds: "It was difficult for the researchers to obtain the information in order to undertake the study in that they don't have the powers of the National Audit Office [NAO]."

Even so, the information is presented in such a way as to reinforce the prejudices of those who may have misgivings about PFI. The report states that trusts have paid a 30% - a conservative estimate - risk premium of construction costs just to make sure the deal has come in on time and on budget. Moreover, between 2000-03, a 26% increase in income will go towards paying for PFI.

With six out of 13 trusts said to be in debt, and four of nine trusts with off-balance sheet PFI projects with serious net deficits, the conclusion that PFI is not affordable is well made.

Paying a premium, however, is not limited to the National Health Service (NHS). The report calculates that in three years the Highways Agency has paid in the region of £618 million for eight projects, compared to the initial cost of £590 million. It is estimated that a premium of 25% of construction cost has been paid by the agency for four design, build, finance and operate (DBFO) road projects.

With figures such as these, the report makes decent reading for those looking to dismiss the Treasury's concept of VFM in relation to PFI. The report also infers that the banks may have charged a higher rate for PFI than the Treasury could have done directly. Moreover, local government borrowing may have been another option that might have been more competitively priced.

Risk transfer costs

With VFM being so closely scrutinized, the costs involved in transferring risk come under some heavy fire. There is a tacit assumption that benefits in kind are being lost and income is being redistributed from the public to corporate sector.

In a market where no two professionals will come up with the same numbers for risk value, it is not surprising that the corporate sector takes a different view. "The difficulty is to attribute a value for the risks that were in the public sector, but have now been transferred to the private sector," says Stephen Paine, Joint Global Head of Infrastructure at UBS Investment Bank.

The report also highlights that lack of accountability and inadequate financial reporting has served "to obscure what the government does not wish to reveal".

This statement was further corroborated by Peter Morgan, head of accountancy development at the National Audit Office (NAO), at an Smi conference on November 10. Morgan questioned the fact that certain public assets, such as schools and hospitals, have failed to appear on the respective balance sheets of the public and private sectors.

"If you assume that the government is not providing Value for Money, it would not want the information in the public domain and might hide behind confidentiality clauses. You have to remember that there's a lot of political capital tied up in this," adds Wynne.

There are also concerns that there may be some equivocation as to who will bear the risk if certain events are triggered. Assets may, in the future, change hands, change use or even suffer demolition. This is otherwise known as "demand risk".

With much of the paperwork confidential, this does not come as a surprise. It is even rumoured that the Treasury has encouraged certain public sector entities to keep these assets off-balance sheet. It is estimated that in the public sector some 43% of projects are on balance sheet; whereas in the private sector, companies such as Carillion, have used special purpose vehicles (SPVs) to ensure the debt gets off their books.

Of course, there are those in the private sector who do not view transparency as an overriding problem. "The cost breakdown, including the equity return, is set out in significant detail in the bid, and thereafter in the contract itself," says White.

Others, however, believe that gaining complete transparency will not come easily. "Bidders don't want complete transparency, because they don't really want their competitors to know what their prices are; the same applies to their building costs," says Jeff Thornton, head of Infrastructure Finance Group at the Royal Bank of Scotland (RBS).

Secondary market

As if the ACCA-sponsored report was not enough, the PFI sector has been dealt a further blow by the National Audit Office. On November 30, the UK's Financial Times ran a story on the investigation into the sale of PFI stakes. As well as outlining the substantial gains made by PFI players over the past few years, the report stated that the NAO review "could increase pressure to share windfall gains with the public sector".

Although this kind of statement makes for good copy, many in the private sector believe that the use of the term "windfall" was emotive and misleading. Even MPs who oppose PFI, from both the Labour and Conservative interest, were wheeled out for quotes on the unacceptability of the potential profits. "It's the kind of comment we've come to expect from the Guardian but not from the FT," muses a PFI expert.

Other critics of the article have been more exacting. "It is not a windfall; it's just a matter of selling the right to receive the future equity return. The price paid is, in effect, the net present value [NPV] of those future equity payments," says White. Furthermore, when equity was invested in the early stages of PFI projects, no one really knew the extent of the risk involved. "The equity is really the buffer that takes the risk of the swings of fortune. It is there to enable the PFI project to withstand potential adverse variations and changes," adds White.

The supposed "windfall" is not actually made at the Government's expense, rather it is the outcome of a carefully drafted subcontract between two private entities. Investors, attracted by predictable yields, analyse the NPV (the sum of future unitary charges deducted from discount as future payments) minus the margin for risk as well as the margin for acceptable returns equation. "The fact that the equity is selling higher than par in the equity market is down to well-managed projects," adds Thornton.

The UK PFI market is worth around £32 billion. This year alone the value of secondary equity bought is £400 million ($740 million), and this figure is expected to rise. At the most conservative 90/10 gearing, some £4.5 billion in stakes could now be on the block.

Excessive equity profits or good management?

One of the latest deals to hit the headlines has been for Carillion. In June, the company sold its 50% stake in the M40 project to the other equity partner, John Laing, for £19.65 million. Carillion's original equity investment in the M40 SPV was £2.2 million and it later purchased additional equity from the SPV partners in 2000 and 2001. At the point of sale Carillion's had generated a profit of over £6 million. However, within four months, John Laing sold on the stake for £26.2 million.

In the hospital sector, Carillion has also managed to clean up. In six years, the company has made four times its initial £4 million investment in the Darent Valley Hospital. It is estimated that on this single asset a profit in the region of £11 million has been made.

With profits such as these, it comes as no surprise that hackles, in certain quarters, have been raised. However, the private sector should not feel the need to have to justify itself. "It is the private sector that creates, and sells, the equity return. The purchaser buys the right to receive the future revenues, taking the risk that they will materialise. The government still pays the same amount of money," adds White.

As yet, it is unclear as to the kind of tone the NAO will take in its examination of the secondary equity market in PFI projects. Nevertheless, it is expected that the NAO will have to analyse the Treasury's reluctance to take a share of the gains on the sale of equity stakes. The current line is that the Treasury makes the gain anyhow by taxing their profits.

But in a letter to the Financial Times, in early December, Jean Shaoul, professor of Public Accountability at Manchester Business School, called the Treasury's reluctance to share in the profits "disingenuous". Furthermore, she stated that the tax take from PFI was low: in some cases 8% or less, dependant on whether tax is deferred.

Given the recent furore over "windfall" profits, an important feature of the secondary equity market has been overlooked: that of its role as provider of liquidity to infrastructure developers.

This liquidity has been instrumental in facilitating the origination of PFI transactions. With bidding costs of £2 million to £5 million per transaction (excluding certain hidden costs), the entry barrier to PFI tenders, in terms of time and money, is substantial - and with no guarantee of winning a deal.

Many bidders hope to achieve a strike rate of 1-in-2 or 1-in-3. Certainly costs have been known to escalate. And the realities of losing a bid can be harsh. So equity is utilised as risk capital to give projects momentum. It is rumoured that a French entity lost up to £10 million on a single bid. "Those outside the industry forget that if you lose, it's dead money," says a PFI specialist.

One of the latest casualties has been Jarvis, which recently reached agreement with German-constructor Hochtief to dispose of part of its PFI business for £1.2 million. The consideration, plus £300,000, is payable should two of its outstanding bids reach financial close within two months of completion of the disposal. The projects include a Manchester schools project, Bangor and Comber school in Northern Ireland, and the Cork School of Music in the Republic of Ireland.

Although PFI has had its fair share of failed and scrapped projects (especially in the IT sector) the failure rate remains low: an argument which fails to convince those opposed to the initiative.

Future rifts

For the foreseeable future, PFI will continue to be an emotive issue in that it has taken outsourcing on to a new level and is seen by many as a form of privatisation by the backdoor. There are also fears that, bar the initial stir the ACCA Report caused, there will be certain long-term effects. According to Paine, "One of the concerns about the report is that certain authorities may be put off the idea of entering the PFI market."

In order to improve the public sector perception of PFI, management and guardianship of assets will need to be improved. In addition, greater liquidity in the market may help mitigate some of the recent criticisms made of the secondary market - more sellers and therefore lower prices.

But ultimately the whole PFI VFM argument is in fact an NPV argument = the direct and indirect economic benefits to UK PLC of cutting edge infrastructure today rather than in 30 years time. The growing secondary equity market is just symptomatic of well-managed projects, so perhaps if the accusations of profiteering stop PFI bankers and developers should begin to worry.