Involvement of Small and Medium Sized Enterprises in the Private Realisation of Public Buildings

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Contents

Abstract

This paper explores the procurement of public buildings in local authorities in the UK under the Private Finance Initiative (PFI) and its consequences for small and medium sized enterprises. Following an outline of the development of PFI in the UK, the paper explains the peculiarities of local authorities' involvement. Opportunities and problems of smaller constructors in such PFI projects are then analysed. Three case studies of smaller PFI schemes are reviewed including procurement process, contract agreement, project funding, risk allocation and innovations. Because of complicated approval frameworks and contract structures more and more projects are bundled in order to obtain a better value for money. Smaller constructors, therefore, can only act as subcontractors until simpler procedures and contracts are introduced by government bodies and organisations responsible.

JEL – classification: H54, H57, L33, L74
Key words: Private Finance Initiative, Infrastructure, SME, Local Government

Zusammenfassung

„Die Beteiligung kleiner und mittelständischer Unternehmen bei der privaten Realisierung öffentlicher Bauten"

Die vorliegende Arbeit setzt sich mit der Beschaffung öffentlicher Gebäude in Kommunen in UK im Rahmen der Private Finance Initiative (PFI) und den daraus resultierenden Folgen für klein und mittelständische Betriebe auseinander. Nach einem kurzen Überblick über die PFI in UK werden die Besonderheiten für Kommunen im Rahmen der PFI deutlich gemacht. Die Möglichkeiten und Probleme der kleineren Baubetriebe sind dabei genauer untersucht worden. Drei Fallstudien kleinerer PFI Projekte wurden anhand der Kriterien Beschaffungsprozess, Vertragsgestaltung, Projektfinanzierung, Risikoverteilung und Neuerungen ausgearbeitet und analysiert. Aufgrund komplexer Bewilligungsverfahren und Vertragsgebilde werden immer mehr Projekte gebündelt um einen besseren Mehrwert zu erzielen. Kleinere Baubetriebe agieren dabei nur als Subunternehmer, solange keine Vereinfachungen durch die zuständigen Behörden und Organisationen realisiert werden.

JEL – Klassifikation: H54, H57, L33, L74
Schlagworte: Privatwirtschaftliche Realisierung, Infrastruktur, KMU, Kommunalverwaltung

Preface

A criticism of the British Private Finance Initiative (PFI) frequently put forward is the claim that it is not suitable for small and medium sized enterprises (SME's). The research work presented here is aimed at investigating this argument in depth. The SME projects examined, a primary school, a fire station and a police station, demonstrate the problems that SME's had to face in the realisation of these projects. These have included substantial transaction costs due to insufficient contractual standardisation and reservations of banking organisations in respect of longer term stability of SME's.

The intention of the Working Paper is to help avoid us in Germany to go through the same learning curve, especially to ensure that the contractor-led model of private realisation of public infrastructure is designed to be more SME friendly. The German speciality of state and co-operative banks, who are the predominant financiers of SME's, can make a positive contribution here.

Freiberg, 29th July, 2002

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Abbreviations

4Ps	Public Private Partnership Programme
AEF	Aggregate External Finance
BAFO	Best and Final Offer
DBFO	Design Build Finance Operate
DEFRA	Department for Environment, Food & Rural Affairs
DfEE	Department for Education and Employment
DFES	Department for Education and Skills
DTLR	Department for Transport, Local Government and the Regions
FRS5	Financial Reporting Standard 5
IDeA	Improvement and Development Agency
ITN	Invitation to Negotiate
LGA	Local Government Association
LIBOR	London Interbank Offered Rate
OGC	Office of Government Commerce
OJEC	Official Journal of the European Communities
PFI	Private Finance Initiative
PFT	Private Finance Transaction
PRG	Project Review Group
PSBR	Public Sector Borrowing Requirement
PSREs	Public Sector Research Establishments
PUK	Partnerships UK
RSG	Revenue Support Grant
SME	Small and Medium Sized Enterprises
SORP	Statement of Recommended Practice
SSA	Standard Spending Assessment
TSS	Total Standard Spending
TTF	Treasury Taskforce
TUPE	Transfer of Undertakings (Protection of Employment)

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1 Introduction

Ten years ago the government thought about new ways of delivering public infrastructure by involving more private sector skills and management expertise than had usually occurred under traditional procurement. The overall aim was to deliver public infrastructure projects with better value for money. The introduction of PFI has been a very successful method of providing public sector infrastructure. At first, the Private Finance Initiative could only be used for central government infrastructure projects, but changes in legislation made it possible for local government to use this new model to deliver new infrastructure as well. The study will especially focus on the procurement of public buildings within local government as part of public infrastructure.

Small and medium sized enterprises have been responsible for the construction of most public buildings within local government before the introduction of new ways of procurement, such as the Private Finance Initiative. It is one aim of this study to investigate whether this situation has now changed or not. Therefore, it is essential to identify which aspects are important or unique to the Private Finance Initiative within local government, which restrictions exist and how local authorities are reacting.

Furthermore, case studies are used to reveal first hand information on small public building projects procured under the Private Finance Initiative within local government. Information that the case studies have brought to light is analysed and evaluated in order to make recommendations for the involvement of small and medium sized enterprises in the future.

Thus, the study highlights some important aspects for both local authorities and small and medium sized enterprises, who want to evaluate the chances and risks of becoming involved in the procurement of public buildings under the Private Finance Initiative.

2 The Private Finance Initiative

2.1 What is PFI?

The Private Finance Initiative (PFI) transforms Government Departments and Agencies from being owners and operators of assets into purchasers of services from the private sector. It is important to mention that PFI is not about borrowing money from the private sector. PFI is all about creating a structure in which improved value for money is achieved through private sector innovation and management skills delivering significant performance improvement, efficiency gains and potentially huge benefits to the taxpayer. There are currently three main types of PFI transactions [URL 1].

Services sold to the public sector

The private sector is responsible for the capital investment and the public sector only pays on the delivery of specified services to specified quality standards. Those projects are generally procured by the DBFO route.

Financially free standing projects

The private sector recovers its DBFO contract costs through direct charges to users (e.g. tolling) rather than from public sector payments. Public sector involvement is limited to enabling the project to go ahead through assistance with planning, licensing and other statutory procedures.

Joint ventures

Joint ventures involve projects where the entire costs cannot be recovered through charges on the end users. The government offers a part-subsidy in order to enable the project to go ahead.

When handled well, the PFI can work to the mutual advantage of users of public services, taxpayers and companies seeking new business opportunities. However, the challenge is considerable. Only by setting out clear priorities and establishing a user-friendly framework within which both the public and private sectors are happy to operate, can the Government make the PFI work as well as it should.

2.2 The History of PFI

The PFI is not a new idea. Italy, France and Spain have used private finance for building motorways for many years whereas Australia, New Zealand and the United States have been using private finance in prison, road and hospital buildings.

Private finance of public infrastructure in England has its origins in the late seventeenth century with inadequate levels of government and local community spending for public infrastructure but with an existing need for the construction of turnpike roads, the construction of canals and the construction of public railway systems. At this point in time, the private sector took the initiative to establish new infrastructure. Due to increasing government control over competition and an increasingly powerful labour market the private investment in public sector infrastructure had declined sharply by the end of the nineteenth century [URL 2].

In the early 1990's, the government faced a lack of sufficient public funds to adequately improve public sector infrastructure. That situation forced the government to create innovative solutions, which would secure needed investments in public infrastructure without further increasing the PSBR. Probably the biggest step for government to achieve this aim was to stop being reluctant using the private sector expertise as much as they could, opening the way for a better use of public funding.

2.2.1 PFI before 1997

The "Private Finance Initiative" was formally introduced by the British Chancellor of the Exchequer, Norman Lamont, in November 1992. Until then, the use of private capital for the funding of public assets had been restricted by the Ryrie Rules. The government saw two main benefits in the adoption of PFI as a popular procurement method.

First, traditional public procurement was characterised by high cost and time overruns and the government perceived that the PFI would offer improved value for money through the accelerated completion and more efficient operation of assets.

Second, if sufficient risk was transferred to the private sector, then the subsequent service payments could be described as current rather than capital expenditure with the result of a decreasing PSBR [URL 3]. In autumn 1993, a rudimentary structure was created to support the initiative consisting of bodies known as the Private Finance Panel and Private Finance Panel Executive. Nevertheless, the main output of the PFI between 1992 and 1997 only comprised a handful of basic Private Finance Panel publications and the number of new projects emerging from the public sector was viewed as poor. Reasons for the perceived shortcomings were:

- The uncertainty of the public and private sector as to how PFI worked.
- Protracted negotiations due to legal contractual disputes.
- Highly detailed output specifications that restricted the degree of innovation put in place by the tenderer.
- Unrealistic government views on risk allocation.
- The inappropriate use of PFI in small scale projects alongside an insufficient administrative system which had to facilitate the tendering process, control changes, settle disputes and thereby increased the high costs of bidding.
- Reluctance of the public sector to appreciate the value of the contribution that the private sector could make.

- Ongoing criticism from the Labour opposition, which was correctly presumed during that period to be a government-in-waiting.

2.2.2 PFI post 1997

The arrival of the new government in May 1997 produced a new opportunity for the Labour government to evaluate PFI as a method of procurement. Their first task was to announce a review of the PFI under the chairmanship of Malcolm Bates, chairman of Pearl Assurance, called the 'Bates Review'. That first Bates Review made 29 recommendations, the most significant of which was that only viable projects should be brought forward for consideration as a PFI project [URL 4]. The Private Finance Panel and the Private Finance Panel Executive were replaced by a Treasury Task Force. Price Waterhouse Coopers were engaged to train certain civil servants to become PFI specialists. To limit bid costs, it was recommended that it become compulsory not to shortlist more than four bidders. In the event of cancelling the project at a late stage by the purchasing department, compensation may now be paid to bidders provided that the decision not to proceed was not related to the viability of the tenders received.

A second Bates review of the PFI was completed in March 1999. This has led to the replacement of the Treasury Taskforce by the newly formed Partnerships UK.

2.3 Organisations promoting PFI

2.3.1 Partnerships UK

Partnerships UK emerged out of the Treasury Taskforce (TTF). The TTF consisted of a policy team and a project team. This structure was broken up in such a way that the policy team became integrated into the Office of Government Commerce (OGC), which is a wholly public sector organisation forming a part of the Treasury. This means, for example, that the work on standardisation of contracts, which was one of the TTF tasks, has now transferred to the Policy Unit of the OGC, who are now responsible for issuing new standardised contract documentation. The projects arm of the TTF, which represented most externally visible activities, has been handed over to Partnerships UK.

Partnerships UK itself is a company with 51% owned by the private sector and 49% owned by Government. An Advisory Board was set up with its first meeting in January 2001. It is a mix of some Permanent Secretaries, experienced practitioners and key existing clients. The board will meet twice a year and PUK will report to them on a historical basis and will outline plans for the future [URL 5].

The main tasks of Partnerships UK include of the following:

- Acting as a Public Private Partnership developer by working in partnership with public bodies.
- Continuing much of the work of the TTF by overseeing actual projects, having a contract with the Treasury for providing a help desk for the public sector on PFI and supporting them in producing further standardisation in respect of best practise developing in the market.
- Participating jointly with public sector promoters in the development of individual projects and working alongside external advisers.
- Provision of risk capital to bridge the gap between traditional equity and senior debt in IT schemes through mezzanine financing.

The interests of PUK are aligned with those of the public body. PUK and the public body share the costs of development and procurement of Public Private Partnerships. If a project fails, Partnerships UK loses some or all of its money. If it is a success, PUK and the public body share the benefits.

However, the involvement of Partnerships UK is not only confined to the development of Public Private Partnerships. It will also participate in Wider Market Initiatives and in the development of the UK waterways network. Furthermore, there will be a Commercialisation Unit for Science and Technology, which is trying to find new opportunities to create new businesses on the back of developments sponsored and founded in scientific and technological research in the public sector. Therefore, a new team has been established within Partnerships UK to work with PSRE’s to come up with ideas and developments for commercial exploitation.

2.3.2 The 4P’s

Established in 1996, the 4P’s are a dedicated unit to assist local authorities to develop and deliver PFI schemes and other partnership initiatives. Funded primarily by government grant, the 4P’s are able to offer their services free of charge to local government. Being accountable to a board appointed by the Local Government Association, the 4P’s provide guidance and are developing case studies and contractual documentation to encourage successful approaches to be replicated in other authorities.

Rt. Hon. Nick Raynsford, former Minister for Local Government and the Regions stated:

"PFI in Local Government is helping to develop and improve public services. 4Ps provides invaluable advice and support to Local Authorities using the PFI route for

project financing. 4P's consultancy advice and guidance have played a vital role in ensuring the success of the £7 billion Local Government PFI programme." [URL 6]

Councillor Richard Kemp, Chair of the 4P's, recently commented that the work of the 4P's is divided into four distinct categories:

1. Representing the needs of local government to central government by employing executives who are respected as neutral and factual as they advocate change and initiatives.
2. Providing standardised procedures to enable everyone to learn from previous experience with all the expertise of the 4P's available to local governments on their website (www.4ps.co.uk).
3. To bring together council staff to share the learning experience, realised either by conferences or by regularly convening sector specific meetings of councils going through PFI procurement.
4. To work within the local and central government family to raise the standard of debate about the relationship between the public and private sectors [URL 7].

The LGA Executive has just agreed in principle to an enhanced link up between the 4P's and the IDeA to enable the 4P's to do even more for local government, expanding their work in fields of training and support and the provision of a help desk for local authorities.

3 Local Government and PFI

During the early days of PFI, local government was merely an onlooker, unable to join. However, the government recognised that a system needed to be set up that enabled local authorities to enter into private finance transactions. There are three main reasons for this.

Firstly, local government means very big business. It accounts for approximately 25% of all public sector expenditure. Secondly, local government offers a strong covenant to bankers, and are strong partners to potential private sector partners. Thirdly, there have been years of under-investment in vital infrastructure and capital allocations available for 'traditional' procurement will continue to decline. Unless an authority is rich in reserves, PFI is the only way to secure capital investment.

Nowadays, over 100 local authorities are working to deliver often complex PFI agreements. There are 174 PFI projects in procurement, which are endorsed by the

Project Review Group (PRG). Figure 1 gives a detailed overview of projects according to their sponsoring department at different stages of the procurement process.

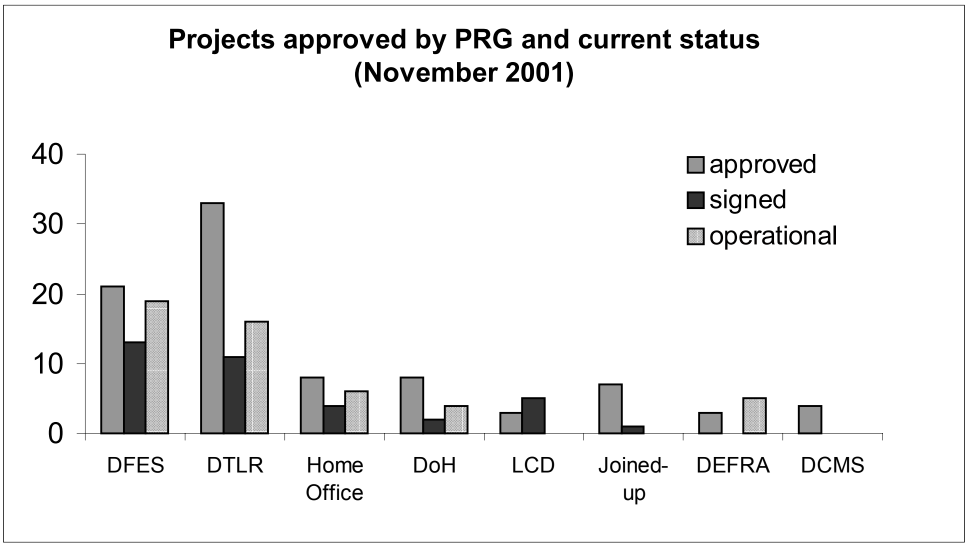

Figure 1: Projects Approved by PRG [URL 8]

For further information, Table 1 shows the allocation of PFI credits by sponsoring department, and gives an outlook until 2004.

PFI Funding by Sponsoring Department and Financial Years in million								
Sponsoring Department	**1997/98**	**1998/99**	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**2003/04**	**Total**
DETR [(a)]	149	200	250	250	332	565	685	**2,431**
DfEE	22	130	350	350	450	550	650	**2,502**
Home Office	41	80	100	100	100	125	125	**671**
DoH	37	30	30	30	40	40	40	**247**
LCD	0	60	70	70	70	70	70	**410**
DCMS	0	0	0	0	30	30	30	**90**
Joined-Up	0	0	0	30	30	0	0	**60**
Total	**249**	**500**	**800**	**830**	**1052**	**1380**	**1600**	**6411**

(a) It includes the 8 waste management projects which belong now to the new department DEFRA; DETR was transformed into DTLR in 2000.
(b) DfEE has been transformed into DFES in 2000.

Table 1: PFI Credits by Sponsoring Department [URL 9]

3.1 Structure of Local Government

Different countries set up their government structure in different ways. This can be extended to the regional level. For a real understanding of the PFI in local authorities, it is essential to know how local government in the UK is structured. Therefore, issues such as "Who is acting as a local authority?" and "What services are the responsibility of a specific local authorities?" need to be addressed.

The first major restructuring of local government in England outside London came into effect on 1st April, 1974. A new structure of 6 metropolitan county councils[1] and 39 shire counties, divided into 36 metropolitan and 296 non-metropolitan districts had been created. Such a local government structure is called a two-tier system, which was also in place in Wales and similarly in Scotland. In 1986, the Greater London Council and the metropolitan county councils were abolished. The remaining functions of the Greater London Council were transferred to City of London, London Boroughs, Inner London Education Authority, the London Fire and Civil Defence Authority, the London Waste Regulation Authority and other bodies. The functions of the metropolitan county councils were passed to the metropolitan districts[2], to waste disposal authorities, to joint authorities for police, fire and civil defence, and transport [URL 10] p.2, see Table 3. The Inner London Education Authorities were abolished in 1990 and the responsibility for education in Inner London was transferred to the London Boroughs.

From 1st April, 1996, the two-tier system in Wales and Scotland and to some extent in England changed to a one-tier system consisting of unitary councils. By 1998, 5 county councils and 59 district councils in England had been replaced by 46 unitary councils [URL 11]. The unitary councils run all local government services in their areas except for the Police. It should be noted that all London borough councils and metropolitan borough councils are unitary councils. Table 2 on page 12 helps to illustrate this.

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[1] Those were Greater Manchester, Merseyside, South Yorkshire, Tyne and Wear, West Midlands, and West Yorkshire.

[2] Also known as Metropolitan Borough Councils.

Single-Tier Authorities	
22	Welsh Unitary Councils
32	Scottish Unitary Councils
26	Northern Ireland Councils
46	English Shire Unitary Councils
32	London Boroughs (see below for the Greater London Authority)
1	Corporation/City of London (see below for the Greater London Authority)
36	Metropolitan Borough Councils
•	West Midlands area: (7 borough councils)
•	Merseyside area: (5 borough councils)
•	Greater Manchester area: (10 borough councils)
•	South Yorkshire area: (4 borough councils)
•	West Yorkshire area: (5 borough councils)
•	Tyne & Wear area: (5 borough councils)
Two-Tier Authorities in England	
34	County Councils
238	District Councils

Table 2: Structure of Local Authorities in the UK [URL 12] p.1, [URL 13] p.2

The brief description of local government structure is summarised in Table 3 on page 13, depicting some major areas serviced by local government in England and the local authority responsible for it.

	Metropolitan areas		Shire areas			London area		
	Joint authorities	District councils	County councils or Unitary Councils	District councils	Police authorities	City of London	London boroughs	Greater London Authority
Education		●	●			●	●	
Housing		●		●		●	●	
Planning applications		●		●		●	●	
Strategic planning		●	■	●		●	●	●
Transport planning		●	■	●		●	●	●
Passenger transport (a)	●		●					●
Highways (b)		●	●			●	●	
Police	●				●	●		●
Fire (c)	●		●					●
Social services		●	●			●	●	
Libraries		●	●			●	●	
Leisure and recreation		●		●		●	●	
Waste collection	●		●	■		●	●	
Waste disposal (d)	●		●			●	●	
Environmental health		●		●		●	●	
Local taxation		●		●		●	●	

Legend

● Local government services and their responsible authority, according to [URL 14].

■ Local government services and their responsible authority differing from [URL 14], according to [URL 12] and [URL 13].

(a) Transport for London (TfL) has responsibility for London buses and in 2001 is expected to have responsibility for London Underground Ltd.

(b) Transport for London (TfL) is the highway's authority for about 5% of London roads

(c) Combined fire authorities are responsible for fire services in the shire areas affected by reorganisation from April 1996 onwards.

(d) Waste disposal for some areas of London is carried out by separate waste disposal authorities. The GLA has strategic, but not operational, responsibility for municipal waste.

Table 3: Responsibilities for major local government services

3.2 The Financial Framework for Local Authorities

For a better understanding of financial matters with regards to PFI transactions from a local authority's point of view, it is essential to provide an overview of the financial framework under which local authorities operate. The function of this framework is to control aggregate public expenditure, encourage efficiency and to ensure that the relative needs of different authorities are taken into account when national resources are distributed. This framework can be differentiated into expenditure charged to a revenue account and expenditure on capital assets.

3.2.1 Revenue Expenditure

Revenue expenditures, also known as current expenditures, mainly focus on pay and other costs of running services except council housing. The following information is derived from 'A plain English guide to the Local Government Finance Settlement' [URL 15] and a House of Commons research paper 'Local Government Finance in England' [URL 16].

The government starts with calculating a Standard Spending Assessment (SSA) for each local authority by taking into account the population, social structure and other characteristics of each authority. Formulas for major service areas[3] have been developed. The SSA of all local authorities, plus special and specific grants funding special services, makes up Total Standard Spending (TSS). About 75% to 80% of the TSS is paid by Government, also known as Aggregate External Finance (AEF), the remaining gap is financed through Council Taxes raised by each individual local authority. The AEF is made up of the special and specific grants, the redistributed amount of business rates and the Revenue Support Grant (RSG). Business rates[4] are paid by occupiers of non-domestic properties to billing authorities and are then passed to the Government. Thus, they are out of control of local government. The business rates are redistributed to local authorities on a per capita basis. The RSG of a local authority is:

- its Standard Spending Assessment; less
- the amount it will get from the national pool of business rates; less
- the amount it would get if it sets its Council Tax at a national standard rate.

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[3] Those areas are education, personal social services, police, fire, highway maintenance, environmental, protective and cultural services and capital financing.

[4] Also known as National Non-Domestic Rates (NNDR).

The RSG is paid in a lump sum and the Government can not influence the local authorities' spending plans. The Council Tax, based on valuation bands, is paid by the residents of domestic properties to the local authority. If a local authority sets its budget requirement at the level of its SSA, the Council Tax would be the same for all properties in the same valuation band throughout England. Generally, the budget requirement differs from the SSA of a local authority. The amount of Council Tax an authority needs to raise is the gap between the budget requirement and the funding it will receive from the Government according to its SSA. Even if an authority's budget requirement succeeds its SSA only slightly it would lead to a significant increase of Council Tax. This is due to the fact that the Council Tax only accounts for about 20% to 25% of the total budget. This puts a major political restraint on local authority expenditure and is called the gearing effect. The Government also has the power to cap a budget requirement if it considers that the budget requirement and Council Tax are excessive. The Government exercises its power in order to protect Council Tax payers from large rises in their Council Tax bills. Examples of calculating the Council Tax and the Revenue Support Grant can be found in Appendix A.

3.2.2 Capital Expenditure

Expenditure not being charged to the revenue account must be of a capital nature. This includes expenditure on the acquisition of a fixed asset, adds to the value or extends the useful life of an existing asset. It is normally funded from capital grants paid by Government, external contribution or internal capital receipts[5]. The present legislative framework governing capital expenditure by local authorities is the Local Government and Housing Act 1989. Credit arrangements are another way of obtaining the use of capital assets. They require a credit cover and the full value of this expenditure scores against the authority's capital resources in the year that the contract begins. PFI in local government works within this framework. But there are rules in place under the current Capital Finance System that "credit arrangements[6], which are structured as private finance transactions[7] and meet other certain criteria[8], do not require credit cover and may qualify for revenue support from Central Government towards the capital cost of such schemes" [URL 17] p.17.

[5] Capital receipts means income from the sale of assets and repayment of advances.
[6] See Section 48 of the Local Government and Housing Act 1989.
[7] Regulation 16 – see 3.3.2.1.
[8] Regulation 40 – see 3.3.2.2.

3.3 The Legal Framework for PFI in Local Government

While PFI was launched in 1992 for central government, no PFI project was signed in local government until 1997. This was due to significant aspects, whereby local authorities differ from other public bodies. Some important differences, published in The Standardisation of Local Authority PFI Contracts [URL 17] pp.15-17, are that they:

"• *occupy a particular position in the Constitution, in the sense that each Local Authority is a wholly independent and autonomous entity, responsible individually for the deals they strike and contracts they enter into, yet Local Authorities derive the majority of their funding from central Government and are, as a consequence, subject to central Government regulation and control;*

- *are directly elected bodies accountable to local service users and Council Tax payers;*
- *have a community leadership role, as facilitated by the Local Government Act 2000 to promote the social, economic and environmental wellbeing of the community;*
- *have decision-making procedures which vary from Local Authority to Local Authority particularly with respect to the level to which decisions on different matters may be delegated;*
- *are monitored by various inspectorates which are responsible for laying down standards, for example, the Audit Commission, the Social Services Inspectorate, and OFSTED;*
- *are required to comply with the Best Value performance management framework and the duties set out in the Local Government Act 1999, to have regard to Best Value Performance Indicators (BVPIs)(7) and to set five-year achievement targets to improve performance to a standard at least equivalent by the top quartile of authorities. This statutory performance management framework will have an impact on the setting of contractual targets and the formulation of Best Value Reviews and performance plans;*
- *are public bodies, governed by public law duties and responsibilities such as the well known principles set out in the Wednesbury case and are obliged to comply with the EU procurement regime and other EU Treaty obligations;*
- *Are creatures of statute which can perform activities only if statutory powers can be identified. One consequence of this is that whilst Local Authorities have freedom to contract, they may only do so in pursuance of their statutory functions and in accordance with legislation which has been introduced to control local government borrowing and transactions akin to borrowing."*

After their election in 1997, the Labour Government tried to remove the barriers by establishing rules and guidelines for PFI in local government. An essential role thereby played the removal of the ultra vires concerns and the inclusion of private finance transaction into the Capital Finance Regulations. Those issues will be next to be addressed. Furthermore, administrative arrangements for approving additional revenue support for PFI schemes will be explained in section 3.4.

3.2.1 Statutory Powers

As mentioned before, local authorities are creatures of Statute and can only act where they have specific power to do so. Acting outside those powers can have serious consequences rendering transactions entered into void, also known as acting "ultra vires". Very well known cases of local authorities acting outside their powers are: "Credit Suisse v Allerdale DC, Credit Suisse v Waltham Forest LBC and Morgan Grenfell v Sutton LBC" [URL 18].

In order to remove the "vires" concern, the Local Government (Contracts) Act 1997 was introduced. The main objectives that Act addresses are:

- Clarifying the powers of a local authority to contract with the private sector.
- Allowing local authorities to have "step-in" rights if the contractor gets into financial difficulties.
- Enabling local authorities to certify long-term service contracts, providing them "safe harbour" protection from legal challenge except by judicial or audit review; and
- Ensuring that the contractor will be compensated if a contract is ever set aside in such a review, also politely called the "relevant discharge terms".

The approach to "vires" issues under the 1997 Act is one of the features unique to local government and is completely different to legislation covering similar issues in other sectors.

3.2.2 Capital Finance Regulations

Beside having the power to enter into PFI transactions, local authorities must comply with the rules governing local authorities capital investments. The two most important regulations, defined in the Capital Finance Regulations, facilitating PFI for local government are contained in regulation 16 and regulation 40. Those regulations form the basis for giving capital finance concessions and revenue support for PFI in local government. The regulations are kept under review by Government and have been subject to change during the last two years. Those changes were necessary to bring the regulations more into line with the local government 'Best Value' regime and the PFI principles, which were being recommended by general guidance elsewhere in the public sector.

3.3.2.1 Private Finance Transaction – Regulation 16

Regulation 16 defines the features of a transaction which are needed for qualification as a PFI transaction, also called a Private Finance Transaction (PFT).

A Private Finance Transaction is defined in Appendix B (section 16 (2)(a)(i, ii)). The remaining features included in regulation 16 are summarised, so that:

- the authority pays fees provided by the contract;
- the fees payable are performance based or a measure of usefulness of the asset or both;
- the payment commences only when the services have started to be provided;
- the transfer of an asset by the authority, typically land, can be included as part of the contract; and
- the terms of the contract can provide for lump-sum payments.

Regulation 16 has been amended several times with the last amendment put in place on the 23rd July 1999. The current regulation is included in the Appendix . Regarding the payable fees, there are no restrictions on the reduction in fees. Profit sharing agreements for income by the contractor from third parties as well as benchmarking arrangements resulting in a downward revision of prices are facilitated by the regulations. The restrictions on the price variations for an increase of the fees were removed by the last amendment of regulation 16. According to the general guidance, the increase in fees is, for example, permitted due to indexation by reference to any agreed index, changes in VAT scope, payments for late service commencement occurred by compensation events, payments for changes in law and benchmarking or market testing of charges relating to certain subcontractor services against market rates [URL 17] pp.22.

3.3.2.2 Regulation 40

Within the Capital Finance Regulations, the regulation 40 is seen as the most important regulation for local authority PFI schemes. Until 31st March, 2000, regulation 40 was known as 'Contract Structure Test'. With effect from 1st April, 2000, regulation 40 was replaced in its entirety. The case studies included here have been signed before 31st March, 2000. On account of their relevance to the case studies, the Contract Structure Test will be explained below. The new test, being effective from 1st April, 2000, will be described subsequently.

The Contract Structure Test

Provided that the PFI scheme was in compliance with regulation 16 and was value for money, the Contract Structure Test had to be passed in order not to provide credit cover for the transaction, "which would otherwise be required for a credit arrangement under sections 48 to 50" [URL 19] p.2 of the Local Government and Housing Act 1989. It is important to note, that unlike in other parts of the public sector, the test had never any direct significance on the determination of the accounting treatment of local authorities PFI schemes. This test was effectively a proxy for measuring the level of risk transfer in a local authority PFT and could not say anything about whether a PFI scheme was off or on the public sector Balance Sheet. In practice, the Contract Structure Test meant that the minimum payment to the contractor does not exceed 80% of the estimated NPV assuming the poorest level of performance and the minimum level of asset usage being accepted without having a breach of the contract agreement. In other words, at least 20% of the fee payable to the private contractor is calculated according to measures of performance or usage and that those 20% are the minimum level of risk transfer that must be achieved in circumstances that fall short to the termination of the contract.

The New Test and Accounting for PFI

In other parts of the public sector, the minimum level of risk transfer in a PFT is assessed through the application of an accounting test. Sufficient level of risk transfer means that the transaction is judged to be off the public sector Balance Sheet. The test applied is set out in Financial Reporting Standard 5 (FRS5). The accounting for local authority PFT has always been in accordance with the CIPFA 'Statement of Recommended Practice' or SORP. Since the update of SORP, considering the ASB Application Note Financial Reporting Standard 5 'Reporting the Substance of Transactions – Accounting for PFI Transactions', local authorities have been required to account for their PFTs in accordance with the requirements of FRS5. To bring local government into line with other parts of the public sector, the DETR has changed the risk transfer test in regulation 40 to incorporate the requirements of FRS5. The new regulation 40 is found in full length in the Appendix B.

Only balance sheet entries, directly relating to assets which are subject of the PFT as defined under regulation 16, are considered in the new test. With the test, no credit cover will be required where there is no increase in any amounts on the authority's balance sheet in respect of the assets provided, constructed or improved under the contract. The two exceptions where balance sheet increases are ignored for this purpose are [URL 19] p.3:

(a) where the authority transfers an asset to the PFI contractor in return for reduced fees; and

(b) where an asset provided under the PFI contract is transferred into the ownership of the authority at the end of the contract.

The general expectation of a PFI deal is that it provides best value for money by transferring a sufficient level of risk to the private sector. Regulation 40 is complying with that expectation in that it requires the local authority to structure deals such that a sufficient balance of risk are transferred to the contractor to enable the transaction to be judged off the local authority's balance sheet. To determine which of the two parties has an asset of the property will depend upon whether it has access to the benefits of the property and exposure to the associated risk which is being quantifiable. The factors of risk being capable for a quantitative analysis are: “demand risk, the presence of any third party revenues, design risk, penalties for under-performance or non-availability, potential changes in relevant costs, obsolescence and residual value risk” [URL 17] p.28. Because construction risk does not have an impact during the operational life of the project, it is excluded from that analysis. Almost all local authorities require central government support[9] to go ahead with their PFI schemes. Passing this test is an essential prerequisite for application of that central government support. In the following chapter, the process for a PFI credit approval and the calculation of the PFI credit will be explained briefly.

3.4 Revenue Support for PFI Projects

3.4.1 The Approval Process for PFI Credits

When undertaking a PFI scheme it is important for the local authority and the contractor alike to know that the local authority has the financial means to procure such a project over its lifetime. Therefore, a new framework had been established in November 1997 to ensure that PFI projects going to OJEC notice (unless the project value is below the thresholds set by the regulations)[10] are financially secured. This included the creation of the Project Review Group (PRG). The PRG oversees the approval process and is responsible for endorsing all local authority PFI projects in England, which will receive revenue support from central government. All meetings of the PRG are attended by the 4P’s. The sum of additional revenue support to local government the PRG can endorse in any year is set by the Treasury Ministers, and is then distributed among the various departments[11]. That creates a competitive environment among the local authorities,

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[9] Also known as PFI credit.

[10] The current threshold (from 1 January 2000 to 31 December 2001) is 5million Euros for works contracts and 200,000 Euros for services contracts awarded by central government (Hickmann 2000, p. 9).

[11] Departments are for example DTLR, DFES, DoH and Home Office

applying for an additional revenue support for their PFI schemes. The process between project identification and procurement for a local authority project seeking revenue support, outlined by Blackwell (2000, p.5) is as follows:

1. Identify the need for the project and justify the business need.
2. Consider the funding options available.
3. Establish the necessary level of support from elected members or others.
4. Will PFI be likely to deliver 'value for money' or 'best value'?
5. Appoint professional advisers for taking advice.
6. Early discussions with the relevant government department.
7. Drafting of the outline business case with advisory input.
8. Secure commitment from elected members or decision makers.
9. Submission of the project to the relevant government department.
10. The responsible department evaluates the project against published criteria.
11. Projects endorsed by the department are submitted to PRG[12].
12. The OGC[13] will scrutinise the project.
13. Endorsement by PRG.
14. Procurement may commence with a notice in the OJEC.

The aim of such a process is for local authorities to produce the best business case possible and to consider the departmental criteria for favouring special projects, in order to be successful against others in the direct competition for the limited additional revenue support.

PFI schemes, which do not pass the Regulation 40 test but show value for money, can still be put forward for supplementary credit approvals. For self-financing PFI schemes, local authorities do not apply for an additional revenue support from central government, because the costs will be met from revenues generated by the project itself or perhaps from other resources of the authority. Those projects do not require the agreement of the government and do not need to be brought to their attention. From the government's point of view, local authorities should explore the scope for self-financing schemes wherever possible. However, local authorities always try to obtain as much grant money from central government as possible. So, even if they can procure the

[12] The issues the PRG will consider when looking at a project can be found at [URL 20].

[13] The OGC has taken over the role as a chair of the PRG from the TTF; Partnerships UK will only be involved in the appraisal of PRG projects where there is clearly no conflict of interest with its role in co-sponsoring some local authority projects.

project without a PFI credit, they will nearly always apply for such a credit, because this is an additional grant from central government apart from the RSG.

3.4.2 The Calculation of the PFI Credit

The PFI credit is calculated in the same way as it is for traditionally procured capital schemes. That means it will be paid over a large number of years with the annual amount received steadily declining. Generally, the PFI credit is based on the whole life costs of the project in NPV terms. But the whole life costs include components reflecting both the contractor's revenue and capital costs. The PFI revenue support has to be restricted solely to the capital component of the overall costs in order to avoid double counting, because the part relating to revenue cost is assumed to be already catered for in the relevant SSA service element. The two methods for adjustment avoiding double-counting are:

1. The Revenue Abatement Method

The 4P's state that the adjustment is achieved by "abating the estimated whole life costs of the project (i.e. the NPV of the unitary charge) by a pre-determined percentage that is set by the DETR at a level that should reflect the 'revenue' element of the scheme." [URL 21] p. 6. The present figure for abatement of new buildings is 30% of the whole life costs. For replacement buildings, the initial cost of the project is currently reduced by 30%, or, if higher, by the capitalised average annual expenditure on the old building.

2. The Capital Value Method

With this method, local authorities should estimate the capital value of the scheme, which is the net present value of all capital expenditure by the contractor over the whole period of the contract. The discount rate for calculating the NPV for PFI schemes reaching signature in 2000/2001 was 7.9%[14]. More detailed information on departmental PFI prioritisation criteria and on the calculation of the PFI credit can be found in [URL 21] and [URL 22].

[14] That discount rate is only used for calculation of the discount rate of the PFI credit. For project appraisal and the assessment of value for money (PSC), local authorities still need to use the Treasury rate published in the Green Book, which is 6%.

4 The Role of Small and Medium Sized Enterprises

4.1 Definition of Small and Medium Enterprises

Anybody using data series from SME statistics must be careful when comparing such data. This is due to the fact that there is no single definition for SME's. There are two definitions of SME's in the UK, which are broadly used. These are:

The Companies Act

Section 248 of the Act of 1985 includes the definition of a small or medium sized company.

Criterion	Small Company	Medium Company
Turnover	Max £2.8million	Max £11.2million
Balance Sheet	Max £1.4million	Max £5.6million
Employees	50	250

Table 4: Companies Act Criteria

A company qualifies as small or medium if it meets two of the above three criteria in any year, see Table 4.

European Commission

Criterion	Small Company	Medium Company
Turnover	Max 7million Euro	Max 40million Euro
Balance Sheet	Max 5million Euro	Max 27million Euro
Employees	Max 49	Max 249
Independence criterion[(a)]	25%	25%
(a) The independence criterion refers to the maximum percentage that may be owned by one, or jointly owned by several, enterprises not satisfying the same criteria.		

Table 5: European Commission Criteria

To qualify as a SME, both the employee and the independence criteria must be satisfied and either the turnover or the balance sheet total criteria. A large firm is any not satisfying the above criteria. A micro firm is defined any firm which has not more than nine employees [URL 23].

4.2 SME Statistics

The definition criterion for the size of the company within all statistical data represented here was solely based on the number of employees in the firm.

Based on the data of the year 2000, only 25,000 were medium sized enterprises and less than 7,000 were large ones out of the entire business population of 3.7 million enterprises. Small businesses, including those without employees, accounted for over 99% of businesses, 44% of non-government employment and 37% of turnover. In contrast, the 7,000 largest businesses accounted for 45% of non-government employment and 49% of turnover, see Figure 2.

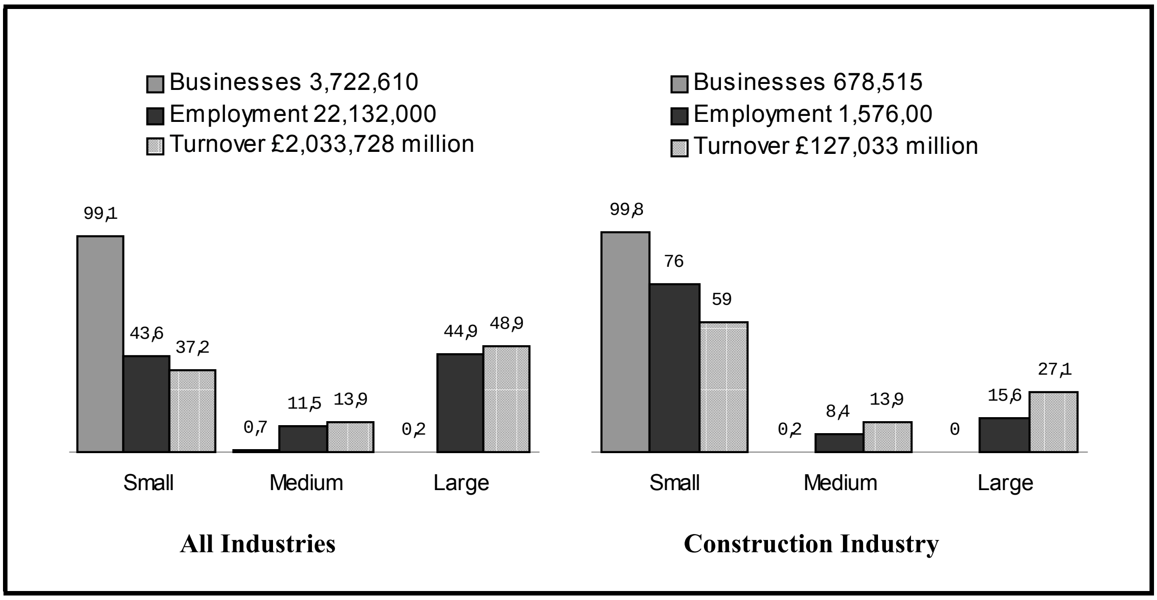

Figure 2: Business Share according to Company Size by Percentage [URL 24]

With focus on the construction sector, small enterprises form a substantial proportion of the UK construction industry, with some 90% of companies employing less than ten staff. Compared to other business sectors, the construction sector has far more people employed in the numerous small companies with a turnover share of 59%. That figure shows that much of the workload is done by small companies. It is also interesting to see how the relationship between turnover and number of employees based on company size is changing. In the construction sector that figure is increasing faster than for the whole business sector, see Figure 2. This phenomenon may be explained by the fact that larger construction companies carry out less work with a directly employed workforce compared to small ones. Most of a large contract is passed on to smaller subcontractors by the large constructor. Compared to other industries, it seems that economies of scale do not play such a significant role in the construction sector.

4.3 Problems faced by SME's in Construction

Small and large construction firms are fundamentally different. Small firms operate in close, localised business networks and are characterised by short-term strategic horizons and simple, relatively static organisational capabilities. Large firms operate in complex, multiple business and institutional networks and are characterised by long term strategic horizons and complex, dynamic organisational capabilities. Therefore small construction companies will sometimes face other challenges and problems than large ones. Figure 3 shows the most frequent problems for SME's collected from all industries.

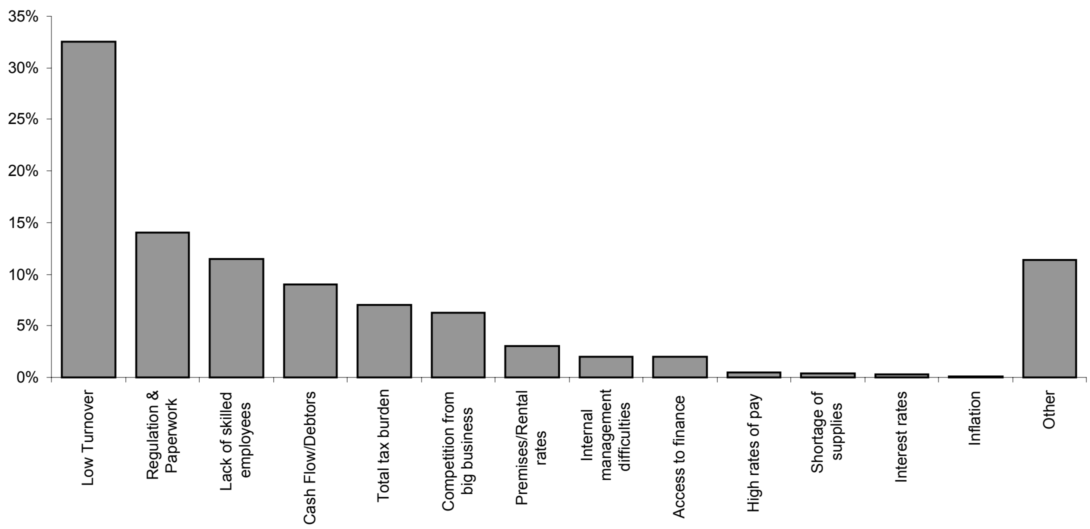

Figure 3: The most important problems facing small firms (March 2001), [URL 25] p.20

The importance of these problems can be applied to the construction sector. Bearing in mind the relationship between employees and turnover from chapter 4.2 and looking at Figure 3, it becomes obvious that neither higher profit margins nor economies of scale have the biggest influence on that figure in the construction sector. Thus, it is probably the low turnover and the rate of capacity utilisation that have the highest impact on it. In the construction sector the low turnover might be explained by the small business criteria mentioned above and the recession in the early nineties when the large companies were encroaching upon the territory of the smaller contractors [URL 26].

Another important issue for small companies is the Cash Flow/Debtor relation that includes late payments. That issue is more present in the construction sector than in any other industry. Small construction firms rely heavily on the income stream of current projects. A lack of payments can therefore create huge gaps within the working capital base of small constructors. In order to improve the situation of smaller constructors, the 'late payment of Commercial Debts Act 1998' was introduced. It allows for any commercial business to pursue any other business for interest and debts [URL 27]. The interest rate is set at 8% over LIBOR. Another way out of this problem, but seldom used by SME's, is factoring. This is due to the high cost to small firms created by the provision of credits to enterprises awaiting payments, along with the service of collecting payments on the enterprises' behalf.

Looking at the funding of SME's by banks including interest payments, the Cruickshank report [URL 28] p.3 points out that there is no effective competition in the UK banking sector. SME's are not offered fair terms and conditions. A few large banks in the UK dominate the market for SME financing and their service is unsatisfactory. The four[15] big banks have a market share of 83% among SME's. Due to this complex monopoly structure, those banks generate huge profits on the back of SME's by providing financial services to them. Because of the current structure, it is only possible for new banks to enter the SME market and create more competition if the government intervenes.

4.4 Strategies for Construction SME's in the PFI Market

When looking for a strategy in the PFI market, it is essential to know that there are fundamental issues which significantly distinguish PFI from normal public sector construction, as shown in Table 6 on page 27.

Therefore, new market opportunities created by PFI need to be tempered by the ramifications of the wrong type of involvement. It is reasonable to assume that most constructors would initially be interested because of the opportunity to increase their normal business. That objective would probably result in simply adding more construction work to the existing portfolio, but it would not be sufficient for a long-term investment in PFI. Given the fact not to be a consortium leader, the long-term involvement would at least require investment of equity, which may take years to yield a return. The Construction Industry Council (1998, p.19) points out that "there is a definite possibility that there will be a market in the sale and purchase of equity in established projects". But bearing in mind, that the transaction cost will increase in relation to a decrease in project size it is, therefore, doubtful that this will work for smaller PFI schemes.

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[15] The four banks are Barclays, HSBC, Lloyds TSB and Nat West

Key differences between traditional public sector procurement and PFI		
Area of consideration	**Characteristics of traditional public sector procurement (generalised)**	**Characteristics of the PFI (generalised)**
Duration of private sector involvement in the project	Until construction of the facility is complete	Normally for at least 25 years for construction-related PFI projects
Specific company involvement	Appointed by the public client on an individual basis for the supply of specific skills	Part of a consortium with the necessary skills or taking a contracting role
Private sector risks	Specific to the area of involvement and limited to defect liabilities	Wide ranging and long term
Remuneration	Lump sum or percentage fee	Annualised payment
Opportunity for private sector innovations	Limited	Considerable
Key financial considerations for the private sector company	Maintaining a positive cash flow and margins	Having an adequate asset base and debt facility
Attitude required of the private sector from the public sector	Reactive	Proactive

Table 6: Traditional Procurement versus PFI, Construction Industry Council 1998, p.10

The following paragraphs explain different possible roles for smaller construction companies within the PFI market, which can be considered when looking for a company strategy.

4.4.1 The Constructor as Consortium Leader and Operator

The constructor can respond to a PFI project by forming the bidding firm. It is well known that the bid for a PFI project is a complex and lengthy process. It requires technical, legal and financial expertise. Therefore it is initially beyond the scope of any single company to provide all the necessary skills, thus requiring the input of specialist advisors and consultants. The employment of some specialists can be achieved using a success fee, but other consultation fees will have to be paid regardless of success. For smaller construction companies, that kind of involvement only makes sense, if there are prospects of establishing competitive advantage in a niche by repeated bidding and innovation or long-term interests in the project, such as facility management, and that the type of project would be straightforward construction with simple operating requirements. A small constructor should therefore choose a strategy which focuses on a special kind of PFI project, such as schools or small serviced offices.

Another hurdle for smaller constructors is the perception of the local authorities of the full range of skills that are expected from the private sector. So it is important that the local authority as client has confidence in what the consortium offers.

A further important issue for the constructor is the funding of the project. Because of a lack of capital resources and liquidity, small constructors seek to contribute as little equity as possible. The remaining money is usually provided through external debt financing by banks. The current minimum amount of equity accepted by banks is about 5% to 15% of the capital value for the project. It is very common that single companies bidding for a PFI project use a special purpose vehicle to undertake the PFI project, so as to arrange the financing of the project on a limited or non-recourse basis. Limited recourse finance means thereby that the parent company will be financially liable to a certain extent for the defaults of the special purpose vehicle. This liability is often indemnified by guarantees from the parent company to the lender, such as parent guarantees for the construction phase of a project.

Apart from private sector concerns at entering the PFI market as a consortium leader and operator there are actions by government which will discriminate SME's when bidding for PFI projects in the future. The NHS Estates announced under its 'Procure 21' route, that all PFI schemes worth between £1 million and £20 million will be bundled together and shared among larger contractors. Thus, the following quote is understandable, where "Procure 21 has been criticised by small builders, who wanted the threshold raised to £4 million" [URL 29]. Smaller firms will only be able to tender for subcontracting work.

4.4.2 The Constructor as a Partner in a Joint Venture

It is possible that a construction company forms a consortium together with an operator sharing the profits between them. That type of arrangement combines the various skills of those experts in the construction sector with those experts in the facility management sector. This has been a very popular and successful route of tendering for PFI contracts. It enables both parties to bid together for more complex projects, ending up with more potential projects they can bid for. That approach is especially interesting for smaller construction firms, which are short of cash reserves or liquidity. For those there is a chance of putting in 'sweat equity', i.e. accepting a shareholding in lieu of payment for development work. Either contributing equity in form of cash payment or 'sweat equity' will add value to the project.

When establishing a joint venture, the parties have to consider the moral hazard problem and the cost of due diligence because of different company cultures and expectations. Those issues can produce a result where a joint venture is just doomed to fail. Therefore, it can be assumed that only long-term partnerships will have a chance of survival and secure a successful business in the established PFI market.

4.4.3 The Constructor as Construction Contractor

The third option as construction contractor appears to be the most traditional role that a constructor can take, by providing construction work in return for reimbursement. It is possible that the concessionaire may want to bundle all construction activities into a construction package and get construction firms to tender for this design and build package. Where the concessionaire contains construction skills, there may be direct management of the construction activities. It is quite common for the constructor as construction contractor to be paid in stages out of finance raised by the concessionaire as work progresses.

The risk associated with construction activities, particularly with the risk of construction-cost increase and late delivery of the completed construction, is usually transferred from the public sector to the concessionaire. The concessionaire has to decide on how much of that risk will be passed on to the construction contractor. On the one hand, the concessionaire absorbs all the risk and employs the construction company under traditional forms of contract, with all the associated risks of delays and claims. On the other hand, the concessionaire is passing on all the risk to the constructor, procuring construction work under a turnkey package with a guaranteed maximum price and a penalty for late delivery or any failings of the completed facility over a predetermined liability period. This implies that the constructor has to carefully consider the risk he is taking on when signing a contract with the concessionaire.

4.4.4 SME's form Consortia

In recent times, local authorities have started to bundle small PFI scheme into large packages in order to achieve better value for money. That has made the PFI packages too big for smaller contractors to bid for as a consortium leader or to take on the role as a construction contractor. However, smaller construction companies see themselves as independent companies and are not willing to only work as subcontractors. Therefore, small builders have begun to pool their resources to form consortia and looser joint-venture arrangements. This movement can be seen as a step to overcome the hurdles of scarce resources and finance in order to be in a better position when bid for a bigger PFI contract. A prominent example for such a consortia, examined by Cavill [URL 30], is 'Portsmouth's 49-strong Key Consortia' which is made up of 49 companies with architects, small builders, quantity surveyors, electricians and plumbers each having 3 to 5 staff. The maximum contract value they will bid for is £5 million. It must be said, that this contract value is at the bottom end for the size of PFI contracts. A medium sized construction company can easily bid for such a project as a single company having the necessary skills or forming a joint venture with an operator as mentioned above. Again, the perception of the local authority for selecting a private partner will prevent them in most cases to deal with a consortia consisting of 49 small companies. They do not want to take the high risk of testing such a management structure. Internally, the consortium has to deal with issues such as: how to spread the risk among members, and how to split profits and losses. One can only conclude that the formation of consortia with many small companies with too few staff provides very little ground to build upon and the opportunities to become involved in 'bigger' contracts will be quite limited.

5. Case Studies

5.1 Case Study Approach

Having examined different strategies for SME's, it is a main objective of carrying out the case studies to investigate whether SME's really can become involved in PFI projects as equal partners in practice, and not merely as a subcontractor.

Given the fact that SME's are restricted by the size and the supply of resources, the main criteria for selecting the projects has been their low net present value. Other selection criteria were:

- The project must be up and running and not be in the procurement process, because the experiences of the private partner's involvement with regards to opportunities and problems occurring are essential for any recommendations that may be made.
- The accessibility to data and information.
- The PFI project had to include the construction of a public building.

The search for relevant projects matching the above criteria was difficult, since only a handful of small PFI projects in local government have been in operation to date. The use of internet databases[16], which contained the status, the value and the kind of PFI project, facilitated the search by far. It must be said, that the database of the 4P's

[16] For relevant internet databases see [URL 8], [URL 31] or [URL 32].

contains information on a project's capital value, as provided by a local authority, which is contradictory to the real figures. According to the 4P's, there appears to be a misunderstanding by some local authorities of the meaning of the term capital value. For clarification, the capital value of a PFI project is the value of its construction cost including the costs for furniture, fittings and equipment, which is also known as FFE.

The relevant information for the case studies has been gathered through structured interviews with the relevant parties to a project and by the provision of additional material by those interview partners.

5.2 Case Study 1 – Victoria Dock Primary School

5.2.1 Introduction

This case study is about the first school in England provided under the Private Finance Initiative, examining the arrangements between Hull City Council and Victoria Dock Primary School Company Ltd.

According to the development of the population in the area, the school was separated into three different phases. Phase 1 comprised a 60 places primary school with a 26 places nursery class including administration areas, two classrooms, a playground and sportsfield. Phase 2 extended the capacity to 120 pupils by adding on two more classrooms and a bigger staff room. Having finished phase 1, the school opened in January 1999. Phase 2 became operational 1 year later. The school will reach its final size after phase 3 by adding on another two classrooms and providing space for 240 pupils. Phase 3 is planned to be open sometime in 2003.
A net present value of £2.7 million and a capital value of £1.5 million for phase 1 show how small and unique the project is compared to other school PFI schemes.

5.2.2 The Procurement Process

5.2.2.1 Background Information

The redevelopment of the industrial area "The Docklands" into an urban village in Kingston upon Hull in the early nineties led to the need of a primary school as an integral part of that area in order to attract new tenants and to promote house sales.

Actually, there was no other option than building a new school. When examining the option of a new school in 1996, it became clear, that there was no sufficient borrowing power by the Hull Education Authority to fund the school in a traditional way. During that time, the authority came across the DfEE road show promoting PFI in education. So, PFI became the only option for procuring the needed school.

Approaching this new concept of procurement, the education authority contacted the PFI department of the DfEE with the result, that they were not supporting the project as it was too small. It can only be assumed that this has been the reason why the Victoria Dock Primary School project did not become a pathfinder scheme. However, despite this the Hull education authority continued with this option and finally overtook all other pathfinder schemes in the educational sector, which showed that they were a true pilot scheme, acting in a loose framework of regulations.

A consequence of this pilot status the procurement process was structured more simply than is the case with current schemes. For example, no outline business case had been produced to obtain the notional credit approval, as no framework for the notional credit approval existed with regards to PFI schemes in education at that point in time.

5.2.2.2 Project Management

Hull education authority started off with a very small team doing the PFI work beside their usual work. Due to the lack of knowledge concerning PFI deals, the education authority decided to appoint external advisers for the financial and legal aspects of the project. The authority received a fixed sum from the government as a grant for external advisor fees, which finally covered about 75% of the overall fees. Eversheds were chosen to work out the legal aspects of the deal. For the financial part of the project the authority selected Deloittes & Touch on the basis that they were also involved in the Dorset school project and that they had some experience from other PFI deals. Deloittes also developed the project timetable, see Table 7. Eversheds was taken on board very early in the process, as there was no model contract and they had to invent an appropriate one. This created unanticipated enormous costs on the legal side.

The total time from OJEC notice to unconditional signing, as shown in Table 7, was 18 months. The delay of 8 months was mainly caused by the negotiations with the preferred bidder, which took much longer than planned. This was offset by the special single team structure of the special purpose vehicle, which made it possible to shorten the construction period by 3 months.

Task	Planned	Occurred
OJEC notice	January 1997	January 1997
Sending out the questionnaire and the marketing brief	March 1997	March 1997
Distribution of ITN to shortlisted Bidders	11 April 1997	11 April 1997
Briefing Day for Bidders	30 April 1997	30 April 1997
Bidders – Deadlines for questions to be submitted by	20 June 1997	20 June 1997
Submission of bids	04 July 1997	04 July 1997
Preferred Bidder and Reserve Bidder selected	15 August 1997	September 1997
Unconditional signing	30 October 1997	02 July 1998
Ground Break	January 1998	August 1998
School occupation	September 1998	January 1999

Table 7: Project Timetable for Victoria Dock Primary School

5.2.2.3 From OJEC Notice to Bidder Selection

The procurement process began in January 1997 with the project notice in the OJEC. Meanwhile the authority produced a marketing brief, describing the project and the form of procurement in more detail, and a preliminary questionnaire. Those documents were sent out to the 12 companies expressing their interest in the project. Only half of the questionnaires were returned. Due to the small number of strongly interested companies, the authority did not do a further shortlisting and issued the ITN to all of them. The ITN had been quite detailed and included the following important parts:

- *Instructions to negotiate*: Including information about the procurement process, compulsory items that had to be considered or included in the bid and the evaluation criteria for selecting the preferred bidder.
- *Building Design Output Specification*: This document laid down the design requirements for school buildings and school grounds accommodation with regards to the school management and its relevant policies, and the operational and capacity requirements.
- *Building Service Output Specification*: This comprised all the performance requirements and quality standards for the estates and management service; catering services (not included in the current contract); care-taking, security and safety services; and the equipment provision and maintenance services.

The bidders consisted of four big companies, a design company and the Sewell Group. The ITN were returned at beginning of July and the authority conducted some further interviews with the bidders. The selection criteria for the preferred bidder were separated into legal, financial and technical aspects all equally weighted. An important point, which the authority included in their decision, was that they asked themselves with whom they could work together for 25 years on a partnership basis without ongoing disputes. The authority did not have a best and final offer. They selected a preferred bidder and a reserve bidder in September 1997. The Sewell Group was awarded preferred bidder status. It was good practise to keep the reserve bidder involved during the negotiation process, but as a consequence of the loose and undefined negotiation process, which caused a lot of problems, the reserve bidder was kept very much in the background. Not having a best and final offer may have shortened the selection process, but it also took some element of competition out of the bidding process and as a result it perhaps did not achieve the best value for money deal possible.

5.2.2.4 Problems during the Negotiation Phase

The delay in reaching financial closure implies that not everything was going smoothly during the negotiation phase. But compared to other projects, the negotiation process was quite short. It is easy to understand that it was difficult to agree on a contract which had never been used before in the school sector. All aspects had to be sorted out on first principles with the help of advisers, who themselves had no experience of PFI projects in the educational sector. The following issues caused a delay in the negotiation process:

- The discussion on the extent of risk transfer in the light of the different attitude to risk by the parties to the contract (see 5.2.3.6).
- The representatives from the education authority at the negotiation table did not have the full authority to agree on certain topics.
- The financier joined the negotiations too late and made decisions which had to be revised in order to have the deal financed.
- The bank originally financing the deal backed out within weeks of contract signature. Sewell had to look for a new bank.
- Non-stakeholders, such as Sewell's and the local authority's financial and legal advisers, were driving the process. They were not motivated to conclude the deal in good time, because they were paid on time spent rather than on a fixed sum.

5.2.2.5 Project Approval

The education authority produced a public sector comparator and a value for money assessment. When the project passed the contract structure test, the education authority was ready to apply for the PFI credit amounting to £1.5 million. The PRG did not exist at that point of time. The whole project was scrutinised by the project board of the Treasury, based on the two key documents which had been submitted and finally approved.

5.2.3 The Contract

5.2.3.1 The Contract Structure

An overview of the contract structure is shown below.

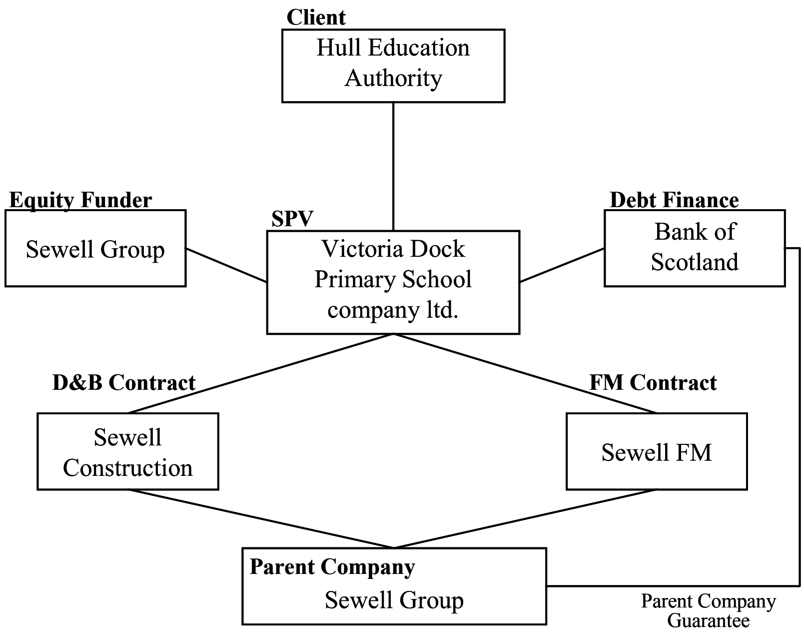

Figure 4: Contract Structure for Victoria Dock Primary School

5.2.3.2 The Consortium Leader Perspective

The SPV is a wholly owned subsidiary of the Sewell Group. Almost everything is delivered by Sewell. That situation refers back to the strategy of being the consortium leader and operator. But, how is a medium sized construction enterprise able to deliver everything from design to facilities management, which, after all, is a complex process requiring different skills.

The Sewell Group is an old family business, which worked exclusively as a construction contracting company up to the late 80's. The UK recession in the early 90's forced Sewell into a position where it had to think about new business opportunities. On the one hand, Sewell went for a vertical integration strategy establishing a design and development department and a facility management wing within their company. On the other hand, Sewell became a retailer for petrol. This structure remained unchanged until today. Sewell has an actual turnover of £30 million a year, half of it is in retail, £12 million come from the construction side and the remaining £3million are generated by the facilities management sector. It employs about 200 people, around 80 in the retail business and 120 in the remaining departments.

Especially the knowledge and skills gained from the vertical integration some years before allowed the Sewell Group to take up the bidder role. Delivering the whole process as a single team gave the company several advantages:

- Fewer disputes had to be resolved during negotiations compared to a project team consisting of several partners, thereby reducing the transaction and bidding cost for the project.
- No disputes about passing on risks to subcontractors;
- Reducing the construction period by three months from tightening up the process by diminishing the interface problems.
- Retaining all profit opportunities, i.e. from the D&B contract, the FM contract and the return on equity funding.

Being Quality Assured to ISO 9002 and BS 5750 was another factor helping the Sewell Group to be selected as preferred bidder.

5.2.3.3 Contract Agreement and Service Specification

It is a 25 years DBFO contract between Hull education authority and the private sector partner. Both parties decided that they were not aiming for dual usage in order to generate third party income. The decision was based on the limited use of the facilities and the exposure to higher risk of the private partner in terms of maintenance, security, building standards and risk of vandalism.

The service agreement includes ground maintenance, window cleaning, waste disposal, security, care-taking, active maintenance, cleaning and plant maintenance and provision of IT hardware. The private sector does not provide school meals, although a fully equipped kitchen is in place. It is still cheaper for the education authority to provide the meals from outside. The teaching service is also provided by the public body. One of the effects of the service agreement is to allow for the teachers to concentrate on their core activities.

5.2.3.4 Performance Standards and Payment Mechanism

The service has to comply with the agreed service standards. There is a walk around every day with a checklist completed by teaching staff. Urgent items are reported immediately to the caretaker from Sewells.

The payment of the unitary charge is separated into availability and performance criteria. The payment structure satisfies the Contract Structure Test, as around 30% of the unitary charge is variable. There is a system in place with penalty points for defaults in major and minor areas, which can affect the income stream. In major areas, as for example the classrooms, Sewells can also be charged for any unavailability. But it must be said, that no deduction of the unitary charge has occurred so far. A benchmarking system in certain areas including the floor area, energy usage and others with other schools ensures that the project will be working under a best value regime in the future.

5.2.3.5 Project Funding

The project finance is split into debt finance and equity funding. The debt finance, provided by the Bank of Scotland, accounts for 90% of the total funds required. The remaining 10% are the minimum amount the bank allowed Sewells to contribute as equity funding. As mentioned before, the HSBC was set to fund the project but withdrew suddenly shortly before contract signature. Sewell had to look for a new bank and found a partner in the Bank of Scotland. The bank was worried when Sewell re-let the FM function and about the repayment of the debt. The duration for the finance to be repaid is only 10 years. The Sewell Group decided to take the market risk and let the interest rate be variable. This proved to be the right decision until now, since the interest rate in the financial model is set at 10.3% and Sewell bought in at a range of 8 to 9% the previous years. Originally, the interest rate was set at 2.5% above LIBOR. But the rate finally came down to 1.75%, firstly, because Sewell could tie phases 1 and 2 together into a bigger package and secondly, since the risk decreased substantially once the school was up and running. So, the bank and Sewells agreed on a parent company guarantee from the Sewell Group for the construction phase. The non-recourse financing situation, a characteristic of project financing, was thereby transferred to a limited-recourse finance situation. The parent company guarantee expired in March 1999, two months after the school went into operation.

5.2.3.6 Risk Allocation

It was not easy for the project parties to identify and quantify all relevant risks which were of concern to the scheme, as there was no risk transfer model in place as it does today. So, 38 risks were listed in a risk matrix, from which 36 risks were passed on to the Sewell Group. Only two risks remained with the education authority. Those were changes in educational legislation and health legislation. Because Sewells subcontracted the mechanical & electrical work including maintenance for 10 years, it could pass that particular risk on the subcontractor. Another aspect, which also can be regarded as a risk, is the increase in business rates. If this should happen the education authority will provide the school with the additional amount as part of their devolved budget.

5.2.4 Positive Factors and Innovations

Schools by their nature, whether they are of small or big size, have to comply with a whole range of regulations according to standards listed in the ITN, see 5.2.2.3. This made it very difficult for Sewells to introduce any innovation to the fabric of the building. A main advantage of the PFI option has been the whole-life-costing approach. As a result of this Sewells installed additional security in the roof and placed shutters on the windows in order to reduce costs, which have come as a result of vandalism and broken windows at times when the school is unattended. It also provides a higher than required safety standard for the people accommodated at the school. The school also receives a dividend payback, which is half the amount exceeding the calculated profit stated in the financial model. This agreement transfers the objective of achieving an efficient service delivery from the service provider back to the staff working at the school. In the first year, £ 5,000 was saved. The money is not paid back in cash. The Sewell Group is using this money to create a wildlife biotope project for use as an external classroom. The positive relationship between Hull education authority and the Sewell Group is further strengthened by having Mr. Paul Sewell sitting as a school governor, which benefits both sides. The school can expect a better service since its needs a likely to be better understood by having a careful listener and the Sewell Group can achieve a better service as it knows what is required of it, avoiding mistakes along the way. Summarising, it can be said that the education authority has received its reward for having the courage to choose a smaller local contractor, who is an integral part of the community.

5.3 Case Study 2 – Stretford Fire Station & Divisional HQ

5.3.1 Introduction

The Stretford Fire Station & 'A' Divisional Headquarter is one of the earliest PFI projects in England procured by the Greater Manchester Fire & Civil Defence

Authority. It was one of seven pathfinder schemes from all fire authorities. The premises include a four bay fire station of some 1,153m² and a divisional headquarters of 368m² for strategic planning. It is designed to accommodate about 20 firemen and 50 headquarters staff including visitors. The contract was signed on 4th December 1998 with the consortium called pff Stretford Limited, a subsidiary of Carden Croft & Co, for a duration of 25 years. The NPV of the overall project is approximately £6.6 million, including construction cost of £3.2 million.

The case study looks at the overall agreement of the project and considers the different views of the fire authority and the private consortium leader.

5.3.2 The Procurement Process

5.3.2.1 Background Information

The increase in commercial activity and the continued redevelopment of the area serviced by the old Stretford Fire Station during the mid nineties led to the opinion, that a fully operational four bay station was needed in the foreseeable future. The old facility, built in 1939, was past its life span in structural and functional terms, and health and safety improvements were urgently required in order to remain operational. With this in mind, the authority came up with four options to address this situation. These options were:

- Do-Nothing
- Minimum Refurbishment
- Major Refurbishment
- New Build

The first three options did not sufficiently address the core operational problems resulting from the outdated design of the current buildings. With regards to both operational requirements and the whole life costs, a complete rebuild of Stretford Fire Station & Divisional Headquarters was the preferred option. But an ongoing reduction in basic credit approval made it impossible to finance the project out of the fire authority's current capital or revenue funding. Therefore the fire authority was willing to submit a PFI pathfinder bid when they were encouraged by the Home Office in January 1997, which was approved in March 1997. As a pathfinder scheme the authority received £ 70,000 from the government to pay advisers and consultants. Probably due to its size, the Greater Manchester Fire & Civil Defence Authority showed a profound knowledge and professionalism in how to approach such a project. While other Fire Authorities were waiting for guidance from the government, the Manchester one was busy developing the required documents on their own. As a consequence, they sold copies of their outline business case to other local authorities and generated an additional income of £12,500.

It is a common feature to build a new fire station on a new site, as the old premises have to operate without any downtime until the new one is completed. With the Stretford Fire Station this was different. The authority decided to demolish the old fire station and to rebuild the new one in the same location. There were two reasons for this decision. Firstly, the fire appliances must be assured to reach any point of the area covered by Stretford Fire Station within a certain time limit. Therefore, the new station could not be situated to far from the old one. Secondly, the ongoing development of this industrial area led to an explosion of real estate prices and it became unaffordable for any party to acquire a new site.

5.3.2.2 Project Team and Advisers

The fire authority set up a small core project team comprising four people, who did all the work on top of their usual workload. They came from the lead authority, Wigan MBC, assisting in legal and financial matters and from the Greater Manchester Fire & Civil Defence Authority, who were responsible for technical and operational matters. The project leader was Roger McLachrie. The authority thus decided to provide most of the professional input by itself, using external advisers only for some additional guidance and monitoring of the steps taken by the authority. This meant, that the authority did not have to pay too much in fees for external advisors, who had not been involved with any PFI deals for a fire authority until then. The fire authority eventually selected Secta as financial adviser, who at that point had some experience with PFI deals in the health sector. On the technical side they appointed WS Atkins, who had an architect with experience in PFI deals. The fire authority also budgeted the cost of the internal advisers and totalled an overall cost of £100,000 for both internal and external advisers. Approximately £20,000 was paid to Secta and the bill of WS Atkins amounted to around £35,000.

Furthermore, the authority put a direct reporting line in place with the project team reporting to a project board and the board reporting to a policy standing subcommittee, which had the authority to approve.

5.3.2.3 Project Timetable

The fire authority produced a detailed project management plan, which was kept under review throughout the procurement. Table 8 on page 34 shows a summary of the timetable for the procurement process.

As long as the authority and Carden Croft & Co had the control of the single task, they were always in line with the planned timescale. The final negotiations were planned to be finalised by July 1998, but were protracted for 18 weeks by the lawyers of the authority, Carden Croft & Co and the bank.

Task	Outturn
Pathfinder Submission	January 1997
Pathfinder Approval	March 1997
OJEC Notice	March 1997
Outline Business Case to HO	June 1997
Shortlisting Bidders	July 1997
Distribution of ITN	August 1997
Receiving Initial Bids	October 1997
BAFO	January 1998
Selection of Preferred Bidder	February 1998
Final Committee Approval	July 1998
Contract signed	December 1998
Occupation of new site	October 1999

Table 8: Project Timetable for Stretford Fire Station

5.2.3.4 Finding the right Partner

In March 1997, the fire authority published an OJEC notice and subsequently sent out 49 questionnaire packages to the parties having expressed their interest to the project. The authority actually wanted to pre-select six bidders for further interviews but received only 6 absolute submissions. Therefore, all were invited for interviews with the result that the authority very quickly reduced the number to three bidders. Two of the six bidders were the same company but represented by different branches, so that they combined their bid. Another one was too weak. The third one pulled out, which was Jarvis construction, because the build costs were only about £3 million and they were interested only in projects with construction cost from £5 million upwards.

In the meantime, the authority submitted the Outline Business case to the Home Office. This document addressed the following points:

- Establishment of Service Need
- Option Appraisal

- Proposed Procurement
- Value For Money & Affordability
- Scope of Satisfying the Contract Structure Test
- Service Performance Requirements
- Timetable

The Outline Business Case was amended by further information and actualised project data in June 1998, and was submitted to the Home Office as the Final Business Case for final approval. The amendments included the payment mechanism, risk evaluation and modelling, financial models for pff Stretford Limited, and a project implementation timetable.

A well structured and robust series of interviews were conducted with the three short-listed bidders within a timeframe of 7 weeks. They had three different meetings, starting with technical interviews, continuing with technical and financial interviews and concluding with technical, financial and legal interviews. This enabled the parties to submit their initial bids only 9 weeks after they had received the ITN. With regards to construction, the national guidance specification was used in the ITN. It may be criticised that the ITN was not detailed enough in its design specifications for the bidding parties. Furthermore, the fire authority was responsible for slightly higher bidding cost of the parties, as they let them produce final bids for two different options. The first one was the re-development on the existing site and the second one was the development based on an unidentified new site. Two of the three bidders were taken to BAFO, because one bidder did not meet the affordability criteria set out by the authority. The final bids were then evaluated against the following criteria:

- Quality of construction and design
- Quality of FM proposals
- Quality of consortium members
- Financial proposals
- Compliance with bid documentation

Both bids offered a sound solution, but Carden Croft had the more detailed proposal and, almost equally important, showed more openness. This convinced the fire authority, since they wanted to go about the project in partnership and did not want to be involved in hard negotiations after having selected preferred bidder. Thus, Carden Croft advanced to preferred bidder. The open relationship between the fire authority and Carden Croft laid the foundation for a smooth negotiation process without any major disputes. Only the lawyers delayed the negotiation process significantly, see 5.3.2.3.

5.3.2.5 Project Approval

The project had the advantage of being a pathfinder scheme. This virtually guaranteed it with the money being there when it was needed. The PFI credit awarded to the project was around £4.7 million, calculated by abating the net present value of the whole life cost by 30%, see 3.4.2. However, due to the loose framework for PFI credit approval at that point of time, the authority had only an oral confirmation that the credit would be awarded by the Home Office. But, the project had to pass the contract structure test and had to demonstrate value for money to the authority. The contract structure test was passed easily with the variable charge representing more than 20% of the overall unitary charge. The main driver, as it should be for making the project affordable, was the quantification of retained risks by the fire authority under a traditional option within the PSC. One main distinction from other PFI projects was that the fire authority used a discount rate of 8.9% instead of the 6% set out in the green book to compare the net present values of the PFI option with the PSC, reasoning that the money had to be borrowed commercially from the private sector. This assumption does not represent a fair approach to the value for money assessment and made it easier for the authority to show that the project reached value for money.

5.3.3 The Contract

5.3.3.1 The Contract Structure

Figure 5 gives an overview of the contract structure.

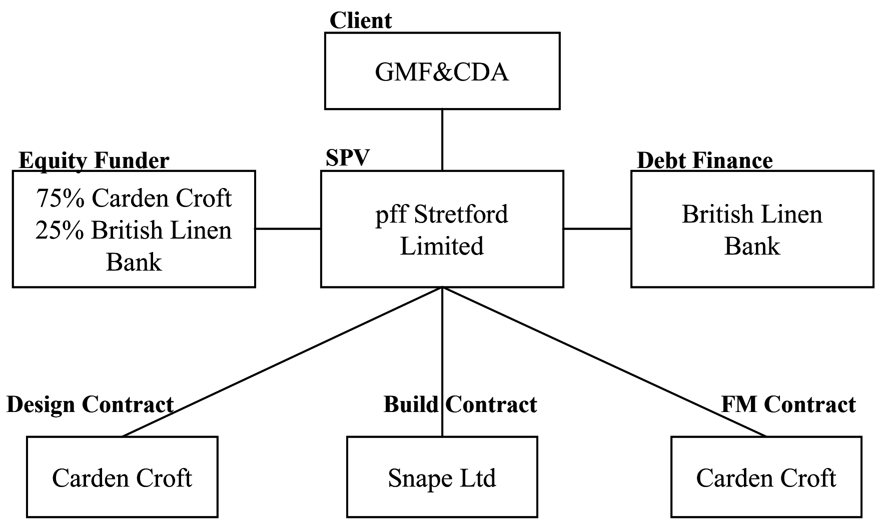

Figure 5: Contract Structure for Stretford Fire Station

Carden Croft set up a SPV only for the purpose of the project called pff Stretford Limited, which is a subsidiary of Carden Croft. The SPV used Carden Croft as the contractor for design, architectural design, project management, planning supervisor role and facilities management. Snape Ltd was contracted for the construction of the building. It is surprising that not only the construction risk but also the design risk was passed on to the builder, who did not know with what intention the architect had designed specific items. Snape Ltd then employed the mechanical & structural engineer Miller Walmsley Partnership, and Shaw Whitmore Fyffe Partnership, for structural engineering and drainage design.

5.3.3.2 The Consortium Leader Perspective

Carden Croft & Co limited was established in 1995 by its two directors Simon Carden and David Croft, who, being architects, brought in a profound knowledge for adopting a whole life approach to building development. A major goal of the business plan was to become involved in PFI not just as designer, but as shareholder and consortium leader. The company employs currently around ten technical staff, including architects and project managers. The facilities management wing employs another 5 to 6 people and was set up for the Stretford Fire Station. Those are basically cleaners, building managers and cooks. The company is looking forward to employ a FM manager in the future, who will be in charge of increasing the business by looking elsewhere. The involvement in PFI helped the company to streamline the up and downs of a small architect, who is on the look-out from project to project. In retrospect, the approach of designing a building with its whole-life-costs in mind has helped the company significantly winning more contracts for its traditional architectural side. As a result of winning the Stretford Fire Station project, the company has developed a quality management system for the FM service and is now quality assured to ISO 9002. The company, together with Snapes Ltd as a joint venture partner, is now also looking at bigger PFI projects. Another strength and advantage of Carden Croft is their openness in dealings with the client including open book accounting.

Carden Croft appointed their accountants Howsons with the task of financial modelling and Property Finance International for negotiating the rates of the bank deal.

5.3.3.3 Contract Agreement and Service Specification

The fire authority and pff Stretford Limited signed a DBFO deal for 25 years. Both parties agreed that the building will transfer to the fire authority free after 25 years, as it is only dedicated for fire service. Furthermore, the authority will receive any remaining funds of the sinking fund, which are left after the 25 year period. The sinking fund is for renewals and repairs and is part of the facilities management charge. The authority has to approve any expenditure which is to be taken out of the sinking fund. With the decision to rebuild the fire station at the existing site, Carden Croft had to create a temporary fire station on a vacant site, within one mile of the existing site, to ensure that fire cover was provided until the new fire station became operational.

Carden Croft as facilities manager is responsible for all non-core operational services. These are:

- Building & Ground maintenance
- Cleaning
- Care taking & janitorial services
- Vehicle fuel storage
- Mechanical & electrical services
- Waste management
- Security & pass control
- Catering
- Furniture provision and renewal
- Utilities & Laundry

5.3.3.4 Performance Standards and Payment Mechanism

The unitary charge to the service provider is separated into a performance based charge and a payment for availability. The whole building is subdivided into priority zones, which are weighted differently for the purpose of calculating the penalties for any availability default. The performance charge is based on the services provided by Carden Croft. The penalties for an availability default seem to be more painful than the performance indicators. Therefore, Carden Croft has put a contingency plan in place to avoid any unavailability wherever possible. For example, if the appliance bay doors fail to operate then the manual back doors can be used. In that case a performance default occurs, but the availability of the function is secured. Only one small default has been reported so far in two years of operation

5.3.3.5 Project Funding

The construction costs of the project are funded by 90% debt finance and 10% equity finance. The British Linen Bank provides the long-term debt, which is to be repaid after 20 years. Carden Croft and the bank fixed the interest rate as a swap rate at around 7% to 8%, since Carden Croft was interested to limit as much risk as possible. The bank tried to reduce its risk with loan life cover or debt service reserve cover. This affected the working capital base of the SPV and pushed up the cost to the authority. In order to keep these increases in cost down to a minimum, Carden Croft kept their return on equity with the bank for the first few years and will take it out at a later stage of the project.

Finally, Carden Croft sold 25% of its equity stake to the bank. The contract provides a return on equity of around 15%.

5.3.3.6 Risk Allocation

A sufficient risk transfer to the private sector partner while considering an efficient risk allocation is one of the key features of any PFI contract. For the process of risk identification, the authority used the risk register for the health sector comprising 1400 risks, which was provided by Secta. They then reduced and adapted this list to their needs and came up with 160 identifiable risks. Values have been put on each single risk, and a quantifiable risk analysis was undertaken by using the Monte Carlo risk simulation method. The identified risks can be categorised as follows:

- Development and construction risks
- Operating risks when the facility is up and running
- Obsolescence risks
- Regulatory and policy risks
- Economic risks

The fire authority transferred most of the risks to the SPV, but retained the following risks:

- Business rates.
- The additional costs for design and construction due to late changes of the design caused by the fire authority. In fact, this has happened. The authority demanded some very late changes to the training towers, which created an extra cost of £17,000.
- Fire service policy changes to the functional content before the facility was commissioned.
- Surge in operational requirements due to local or national disaster.
- Change in size of fire appliances in the future.
- Change in regulations and policies considering design, government structure and authority funding (SSA), law specific to fire service.
- Variation on interest rates caused by the authority delaying financial closure.
- Force majeur.
- Obstruction by the authority, that increases the costs to the SPV.
- Early termination by the authority not in accordance with contract agreements.

Carden Croft attempted to transfer as much risk as possible or reduce the financial implications by means of carrying out their own risk analysis, covering the risk by insurance or developing alternative contingency planning.

5.3.4 Ideas and Innovations

Carden Croft as architects have come up with a number of ideas with regards to the whole life cycle concept of PFI. They designed open plan offices, which would need less space and thereby decrease the construction and operational costs. But unfortunately, this and other suggestions were rejected due to the general working attitude of the fire authority which as grown over the years, where they did not accept any kind of innovation in this respect. Instead of providing a cheaper roof which had to be renewed after several years, Carden Croft decided to offer a conventional roof, consisting of trusses and concrete tiles, guaranteed for 25 years and which should last in excess of 40 years. This variation pushed up the construction costs, but offered the less costly option over the life of the contract. This is a very good example of the opportunities which the designer is presented with in the PFI model compared to traditional procurement. Another area of improvement had Carden Croft come up with a better alternative for the specific non-slip tiles used for the appliance bay.

The fire authority was innovative in its own way by trying to make the project affordable for the authority. As mentioned before, they will receive what is left in the sinking fund after 25 years. In addition, they get a share of the surplus, above what has been calculated in the financial model. Furthermore, the authority has set up a unique type of fund called a PFI equalisation fund. Early savings accrued from the project, which come from lower net cost to the authority using PFI compared to traditional procurement, will be placed into the fund. Assuming a rate of 7.25% on the money saved, the total net cost to the fire authority adds up to £180.000 in NPV terms.

5.4 Case Study 3 – Ilkeston Police Station

5.4.1 Introduction

The Ilkeston Police Station is the first serviced accommodation PFI scheme in the police and local authority sector. It has been awarded as a PFI pathfinder scheme by the Home Office. The project is not, by any means, a large one, having a capital value of £2.7 million and a net present value of £5.3 million.

The new police station is built on a new site replacing the 92 year old station at Wharncliffe Road and it serves an immediate population of 48,000 people. The building, providing accommodation for 106 officers, is a 1,345m² facility on two floors, and includes a 274m² custody suite on the ground floor. A secure and public parking is integrated in the external area. In October 1998, the station became fully operational. Almost no information about the project was given by the police authority. Therefore, this case study primarily focuses on the consortium leader's perspective.

5.4.2 The Project Timetable

Table 9 shows a brief timetable from pre-qualification to occupation of the site.

Task	Outturn
Pre-qualification of bidders	February 1996
Long-listing of bidders	March 1996
Short-listing of bidders	August 1996
Selection of preferred bidder	November 1996
Conditional closure	December 1997
Home Office approval	December 1997
Unconditional Signing	February 1998
Start on Site	March 1998
Practical Completion	September 1998
Occupation	October 1998

Table 9: Project Timetable for Ilkeston Police Station

The delay between the selection of the preferred bidder and the conditional closure was caused among other things by the development of rules and regulations for local authority PFI projects during that period. Another reason was that negotiations between the preferred bidder and the bank's lawyers became quite protracted. As a consequence the start on site occurred three months later than actually planned, but the project was still completed on time. In effect, the construction period was shortened to only 29 weeks. The police authority had a big stake in making this happen, since they produced a very clear and complete output specification and had a project manger in place who resisted any unnecessary changes taking place.

5.4.3 The Contract

5.4.3.1 The Contract Structure

The SPV called Boltercourt Ltd is owned by John Kirkland, a director of Bowmer and Kirkland Ltd, and it was only set up for the purpose of the Ilkeston Police Station project. The design and build of the building services is carried out by Derry Building Services, including the mechanical and electrical installations. Keycare Ltd, as the facilities manager, has now subcontracted the maintenance of those services. Both, Keycare Ltd and Derry Building Services Ltd are wholly owned subsidiaries of Bowmer and Kirkland Ltd.

The following Figure 6 gives an overview of the contract structure.

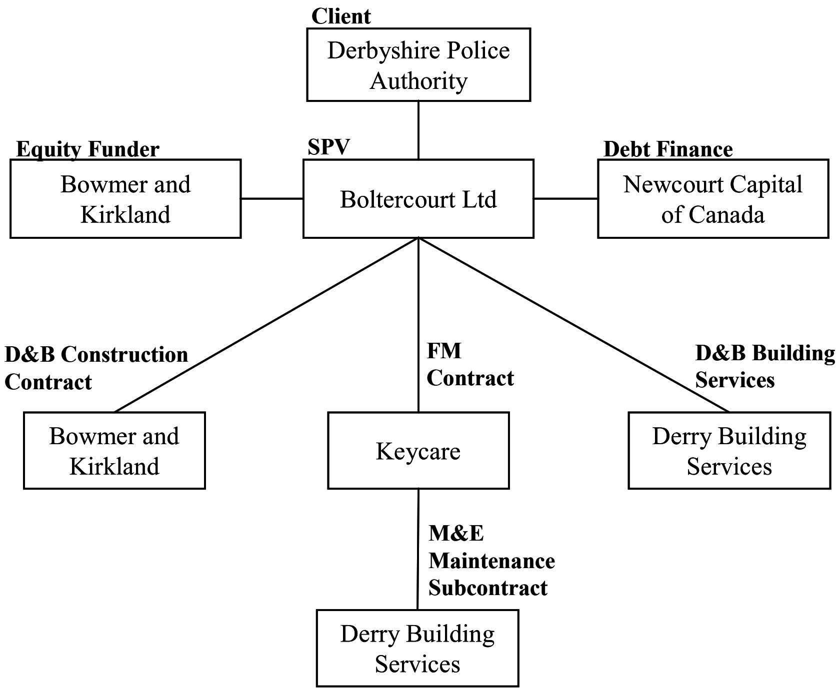

Figure 6: Contract Structure for Ilkeston Police Station

5.4.3.2 The Consortium Leader Perspective

Bowmer and Kirkland Ltd. is a 78 year old and 100% family owned company, which employs 1,300 people in 22 separate companies within the group. With an actual turnover of £420 million this year, the company is now 16th or 17th largest in the league table of UK construction companies.

The involvement of the company in PFI projects started with the Ilkeston Police Station. Nowadays, the company has established its own PFI unit that works very closely with the design and build department. In 1996, when this PFI scheme came up, the concept of a whole-life-costing approach was new to the company. So they employed Chestertons FM to assist them in the calculation of the whole-life-costs. Bowmer and Kirkland are now able to do the whole-life-costing on their own, which also has benefits for traditional work where, for example, a client is interested in the long-term cost of a project.

The bidding costs have been very high in respect to the size of the project. Legal cost made up the biggest proportion of bidding costs. The company saw the bidding costs as an investment in understanding the whole process.

As mentioned before, Bowmer and Kirkland was able to reduce the construction period by three months, but only by taking a higher risk than planned. They commenced the detailed design, and placed orders for structural steelwork and precast concrete prior to unconditional signing in February 1998. It is also worthwhile to mention, that the facility was not only completed in time, but also within budget and to a high quality.

Within the last 4 to 5 years, the company has adopted different roles in PFI deals. These have been as consortium leader, as happened at Ilkeston, or just being the construction specialist. Once they go for a construction contract, Bowmer and Kirkland always do the design for the facility.

5.4.3.3 Contract Agreement and Service Specification

Derbyshire police authority and Boltercourt Ltd. have signed a deal for 30 years with an option to extend for a further 20 years. The service provider is responsible for the following tasks:

- Building and engineering maintenance
- Cleaning and domestic services
- Catering / janitorial services
- Grounds maintenance services
- Furniture provision, replacement and maintenance
- Pest control
- Energy management
- Waste management (including disposal)

The Constabulary retains responsibility for telephone, radio and IT equipment, but has to be connected to the service provider's infrastructure. Furthermore, services as the management of the custody suite from an operational point of view and taking responsibility for transporting prisoners are also met by the Constabulary.

The care-taking, janitorial and cleaning services were to be substantially met by TUPE transferees from the existing Wharncliffe Road Station. That has assisted a smooth occupational start-up of the new police station. The scepticism regards TUPE transfers vanished by the way Bowmer and Kirkland approached this topic. New job descriptions, payment structure, corporate identity, uniforms, management structure and of course the new facility encouraged the transferees to settle in with enthusiasm.

5.4.3.4 Performance Standards and Payment Mechanism

The unitary charge consists of a charge for performance and a charge for availability of the building. The penalty system for performance defaults is related to single categories of the service agreement and there will be a deduction of the overall charge if the service provider fails to perform correctly. The 'building and engineering maintenance' category was excluded from the performance charge, so that the sinking fund is protected. The contract structure test has been passed easily with around 28% of the unitary payment being on a variable performance charge. It should be noted, that there has not been any default during the last three years of operation. The procedure for monitoring and policing the service level agreement includes the following; Notices, Rectification Periods, Remediation Plans, Temporary and Permanent Solutions, Specific and Individual Penalties and so on. For the availability charge, the whole area is separated into five different priority zones, which impose different penalty deductions.

Finally, there will be reviews of the performance and different benchmarks in certain areas of service provision.

5.4.3.5 Project Funding

Debt finance has been provided by Newcourt Capital Canada and represents 90% of overall funding. The remaining 10% are financed through equity capital by Bowmer and Kirkland. The negotiations with the bank's lawyers have been quite a problem and caused a significant delay prior unconditional signing. The bank did not want to take any risk, and so the legal cost were wrapped in the credit offer. Furthermore, the bank was very picky about the risk transfer in respect of the construction period. Having been frustrated after weeks of negotiations, Bowmer and Kirkland finally decided to finance the construction of the police station on their own and to take out the money from the bank once construction was finished. They could only do that, because they were quite cash rich. Nowadays, Bowmer and Kirkland offer this option as a bidding advantage depending on the size and duration of the contract. The interest rate for the debt finance was fixed at 1.5% above LIBOR as a swap rate at the day of contract signature. The return on equity, as assumed in the financial model, is calculated at around 15%. The return on construction cost was around 7%.

5.4.3.6 Risk Allocation

With regards to funding the project, Bowmer and Kirkland was prepared to take the risk on board they could control, i.e. they provided the finance for the construction of the building. But they eliminated the risk of interest rate changes, as this is something they cannot control. Furthermore, the company has introduced a separate index for the energy cost apart from the usual retail price index which is used for the rest of the service payment. This was done due to the unpredictability of the energy cost in the market. The risks, which the police authority have retained, are:

- Changes in business rates and council tax.
- Operational changes requiring specific building and/or service variations.
- Wilful damage.
- Consequences of discriminatory legislative change.
- Financial consequences of any ultra virus ruling.
- Additional charges for special cleaning of cells.

Risks such as fire prevention and health and safety are shared among the contracting parties.

5.4.3.7 Innovations

Bowmer and Kirkland have applied the whole-life-costing approach to all aspects of the project. As a consequence, they have tried to make the building as efficient and maintenance-free as possible. One example for this are the alternatives they considered for the floor finishing in the cellblock. The company also came up with a unique way of solving the custody suite construction in a very efficient way. This involved pre-cast concrete elements, which were made offsite. However, the particular rules of the Home Office design guide did not allow too many innovative solutions to be put in place by the constructor.

Another positive move of the private sector partner was to involve the client all the way through and not only the decision makers but also those who are to become the occupiers and users of the building. This guaranteed that the phase of occupation went very smoothly.

5.5 Analysis and Recommendations

All three projects, that were selected for the case studies, have fulfilled the selection criteria as set out in 5.1. They represent a good mixture of local authorities and private sector partners. It is more an advantage than a disadvantage, that the consortium leader in case study 3 is not strictly a SME, thus allowing opportunities for comparison. A summary of some key elements of the case studies is given in Table 10 on page 53.

Important categories	Case Study 1	2	3
Kind of fabric	Primary School	Fire Station	Police Station
Net Present Value	£2.7million	£6.6million	£5.3million
Contract Length	25 years	25 years	30 years
PFI credit	£1.5 million	£4.7million	£3.8million
Equity proportion	10 %	10 %	10 %
Loan repayment period	10 years	20 years	Not known
Type of interest rate for loan	Floating	Fixed	Fixed
Period between OJEC notice and occupation of the building	24 months	33 months	33 months
Contract includes bench-marking for the provided service	Yes	No	Yes

Table 10: Key Elements of Case Studies

The information used in this section is based on the case studies as well as on additional information gained from interviews. The additional information is based on current experiences made by the private sector parties, not necessarily having a direct link to the case studies, since all of them are still involved in PFI deals.

The issues to be analysed should help the various parties involved in PFI projects to make the right decisions in the future.

5.5.1 Procurement

Two out of three local authorities have provided detailed information about the procurement process for a PFI project. The user of this information should bear in mind that all three projects have been among the first PFI projects within their departments. The procurement process has, therefore, been much looser than what needs to be done nowadays. Some important and current regulations for local authorities can be found in chapter 3.

Considering the number of companies who have expressed their real interest in the PFI projects, shows that only a few companies were definitely interested in bidding for such a project back in 1997. Nevertheless, all bidders went through a process of stiff competition. The bidders that were selected have made their first steps on climbing a steep learning curve and thereby gained a competitive advantage over other companies. Another question is, whether it is advantageous to select a preferred bidder and to keep a 2nd bidder in the background or to go through a BAFO procedure. On the one hand, deciding to go for the BAFO route will create additional costs for all bidding companies, but on the other hand the competition among the bidding teams will be greater. Thus, offering a local authority a deal with a better value for money. Selecting a preferred bidder will have the advantage of a shorter procurement process with lower cost for bidders. However, this will only work if the reserve bidder is kept in the background to produce a detailed bid only when called upon to do so should the preferred bidder drop out.

A problem has come to light in a situation where the PFI deal includes the acquisition of a new site in order to deliver the project. The search for a new site is usually restricted to a certain area, which limits the choice to only a few suitable sites. In this case, the site acquisition can become the decisive criteria in selecting the contractor, which is detrimental to the selection of the best contractor. Furthermore, the prices for possible sites would jump above market value, which would result in a higher contract price for the local authority. In order to avoid such a scenario, the local authority should acquire the site and let the bidders know about the price.

Finally, the authority has to make it very clear what they require from the project in order to secure a smooth and fast procurement process. This means that the local authority should spend the right amount of time in developing an output specification which should not be subject of ongoing change afterwards.

5.5.2 The Involvement of Legal Advisers

The general opinion is for fees payable to lawyers to create unnecessary high bidding cost for the contractor. Most of the time the negotiations between the preferred bidder and their bank or the authority are protracted only by the legal side. The lawyers are paid for their time spent on the project and therefore do not have much interest coming to an agreement too soon. A situation ensues where the lawyers finally drive the process to come to unconditional signing and not, as it should be, the stakeholders of the project. The case studies incurred high legal cost as well, but this was due to the situation where no document existed, which was ready to use by the local authorities and the contractors.

In future, it will not be possible to agree on a fixed sum for legal advice. Nevertheless, it will be very important for the contractor to install a controlling mechanism, which provides a measure of transparency over a lawyer's budget and its use. Bowmer and Kirkland, for example, involved their lawyers very early in the project, only to review the documentation in a superficial way and to single out what seemed to be quite unusual. Afterwards, the lawyer was kept in the background until the company became short-listed as one of three. Additionally, the contractor should agree a budget with its legal advisers and let them report on a regular basis to account for expenditure against budget.

5.5.3 Contract Standardisation

The case studies have been used as precedents by the government in order to bring the standardisation of contracts forward. A lot has been done until today to standardise contractual agreements and thereby making the procurement more cost-effective. But reality shows that the process of developing standardised contract templates is behind the market development of PFI projects. Coming to contract signature still produces very high bidding cost. Furthermore, the lawyers negotiate such elaborate contracts that they can be used for projects worth £ 20 million, which let's one conclude that projects, as examined in the case studies, would not be carried out as a single project nowadays. Today, it is common to bundle such small projects together into one large package in order to obtain better value for money for the local authority, with the effect, that SME's are excluded from bidding for such projects due to their size. So, there must be further development of simple contract templates for small projects, in order to make them affordable for the local authority and to ensure that the procurement process becomes less complicated and faster.

SME's have accounted for about 75% of all public construction work prior PFI for local authorities coming into action. With the introduction of PFI, bigger constructors have taken a large proportion of that 75%. Even if SME's become subcontractors, they will loose a part of their workload and become increasingly dependent on bigger constructors. Meaning, that a large amount of their profit is transferred to bigger constructors and that many of the existing small and medium sized constructors is threatened.

5.5.4 Project Funding

The case studies demonstrate how there is a common structure for funding small PFI deals. A big proportion of the project finance is provided by debt funding and the remaining amount is put in as equity capital. It should be avoided, however, that there are too many equity holders forming an active part of the consortium, since this would create additional cost for due diligence among team members. The provision of equity capital is always a painful obligation for SME's, as they generally lack sufficient capital resources. The establishment of a market for trading equity capital, as mentioned in 4.4, does not seem to be a feasible prospect for smaller PFI projects. Furthermore, banks do not want to take any risk. Therefore, the contractor is very often asked to provide a parent company guarantee for the construction period, which returns the non-recourse finance to limited recourse finance. Even more frustrating for smaller contractors is the fact that bigger companies are able to cover all the construction risk of smaller projects directly by pre-financing the construction of the building with own cash reserves, see section 5.4.3.5.

The case studies have shown, that the interest rate for debt finance is not a significant issue to prevent SMEs to bid for a PFI project. One explanation could be that the most significant risk, represented by construction risk, is covered by guarantees or the like. Another reason points to the local authority as a client representing one of the best covenants. Finally, it must be said that PFI for procuring public buildings have proved to be less risky than anticipated by local authorities and banks. This realisation should strengthen the banks' confidence in providing smaller contractors a good deal as well by reducing debt cover ratios etc., when they can demonstrate sufficient knowledge and expertise.

5.5.5 Whole-Life-Costing

The dominant advantage of PFI compared to traditional procurement lies in the combination of construction and operation of a building. With traditional procurement, the public sector will always try to build as cheap as possible, due to the lack of capital resources, without taking into account the higher maintenance and operational cost later on. The case studies have shown that the contractors have used the whole-life-costing approach to create a better deal for the local authority. The buildings have been designed to be as maintenance free as possible over the life of the contract. The restrictive design guides and regulations of the local authorities were a hindrance for further innovation by the contractors with regards to whole life costs. It is important to note that the approach of whole-life-costing has been a new method of designing a building for the private sector as well as for the local authorities. The contractors have transferred this knowledge gained from PFI to their traditional work, thus giving them a further competitive advantage.

5.5.6 Risk Allocation

The transfer of risk to the private sector is the most important issue for local authorities to consider in order to obtain value for money. The local authorities of the case studies have tried to pass as much risk as they could to the private contractor. It should be kept in mind, that the private sector can bear all the risk which can be priced, but it only makes sense to transfer the risk when it is cheaper for the contractor to do so. A good example in all case studies was the discussion of who would bear the risk of an increase in the business rates. Finally, the local authorities took that risk, because they assumed that it would be cheaper for them over the long term of the contract.

6 Summary

The introduction of PFI in local government required a rethink by local authorities and the private sector alike, it being a complete new way of procuring public buildings as part of public infrastructure. The legal and financial framework for local authorities had to be changed in order to make PFI work within local government. The short-term involvement of construction contractors in the role of builders only has changed to a long-term relationship between local authorities and the private sector, who is now financier, designer, builder and operator.

The case studies show that it was possible to procure small projects during the early days of PFI in local government, thus enabling smaller companies to take on a leading role. But regulations and approval frameworks for local authority PFI schemes have become tighter. This has led to the current situation where local authorities are moving towards large schemes or where they bundle several small schemes together in order to gain better value for money. Inevitably, smaller constructors are excluded from becoming consortium leaders or construction contractors. The original workload of smaller constructors is thereby transferred to the bigger construction companies. Before SME's can go out again and look for opportunities in the PFI market, the government is asked to simplify contract agreements and to produce standardised contractual modules to bring small PFI schemes back to life.

Another important result of the study is to show that there is not a single best solution for a well working contract structure. The nature of the PFI model has provided opportunities for small architectural and facilities management companies to play a vital role in the future PFI market. Those enterprises should be encouraged to consider the PFI market as a market niche they can step into, whereas small and medium sized construction companies are suffering from the Private Finance Initiative.

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Appendix A

Calculation of actual Council Tax

	Authority X (Low SSA, high resource)	**Authority Y** (High SSA, low resource)
Scenario 1: Assuming Budget Requirement set at Standard Spending Assessment		
Budget requirement	£310.00 million	£360.00 million
less income from redistributed business rates	- £135.00 million	- £135.00 million
less Revenue Support Grant	- £ 54.35 million	- £136.10 million
= Actual Council Tax needed	£120.65 million	£ 88.90 million
Divided by the council's estimate of Council Tax base (this assumes they will collect Council Tax from 97% of their Council Tax base)	÷ 184,300	÷ 135,800
Equals **Council Tax level for band D**	**= £654.64**	**= £654.64**

Note: The budget requirement is equal to the Standard Spending Assessment, and both councils make the same estimates of the proportion of the Council Tax base they will successfully collect Council Tax from, so the Council Tax level set is identical. This is achieved because the Revenue Support Grant lets councils set the same Council Tax if they set their budget requirements at the level of their Standard Spending Assessments .

	Authority X	Authority Y
Scenario 2: Assuming Budget Requirement set 5% above Standard Spending Assessment		
Budget requirement	£325.50 million	£378.00 million
less income from redistributed business rates	- £135.00 million	- £135.00 million
less Revenue Support Grant	- £ 54.35 million	- £136.10 million
= Actual Council Tax needed	£136.15 million	£106.90 million
Divided by the council's estimate of Council Tax base (this assumes they will collect Council Tax from 97% of their Council Tax base)	÷ 184,300	÷ 135,800
Equals **Council Tax level for band D**	**= £738.74**	**= £787.19**

Note: With the budget requirement 5% above Standard Spending Assessment, authority Y has to raise an extra £18 million (compared with authority X's £15.5 million), and has a smaller Council Tax base from which to raise it. So, the Council Tax level for authority Y is higher than that for authority X.

	Authority X	Authority Y
Scenario 3: Assuming Budget requirement set 5% below Standard Spending Assessment		
Budget requirement	£294.50 million	£342.00 million
less income from redistributed business rates	- £135.00 million	- £135.00 million
less Revenue Support Grant	- £ 54.35 million	- £136.10 million
= Actual Council Tax needed	£105.15 million	£ 70.90 million
Divided by the Council's estimate of Council Tax base for tax-setting purposes (this assumes they will collect Council Tax from 97% of their Council Tax base)	÷ 184,300	÷ 135,800
Equals **Council Tax level for band D:**	**= £570.54**	**= £522.09**

Note: If budget requirements are set below Standard Spending Assessment, the Council Tax level for authority Y will be lower than for authority X.

Calculation of the Revenue Support Grant

	Authority X (Low SSA, high resource)	**Authority Y** (High SSA, low resource)
Population	540,000	540,000
Standard Spending Assessment	£310 million	£360 million
Council Tax base (number of band D equivalent	190,000	140,000
Council Tax for Standard Spending	£635	£635
Distributable Amount per head	£250	£250
Population x Distributable Amount per head = Income from redistributed business rates	540,000 x £250 = £135 million	540,000 x £250 = £135 million
Council Tax base x Council Tax for Standard Spending = Income from Council Tax if set at the standard rate	190,000 x £635 = £120.65 million	140,000 x £635 = £88.90 million
Standard Spending Assessment	£310.00 million	£360.00 million
Less income from redistributed business rates	- £135.00 million	- £135.00 million
Less standard Council Tax income	- £120.65 million	- £ 88.90 million
= Revenue Support Grant	**£ 54.35 million**	**£136.10 million**

Note

Both authorities have the same population. However, authority X has a lower Standard Spending Assessment (SSA) but higher resources (in terms of the Council Tax it should receive if it set its Council Tax at the same level as Council Tax for Standard Spending). So authority X needs less Revenue Support Grant to make up the difference between its SSA and its resources.

Appendix B

<u>Private Finance Transaction – Regulation 16</u>

The definition of a PFT under Regulation 16 is set out as follows:

"Meaning of a private finance transaction

16(1) in this regulation-"asset" means-

(a) any tangible asset, including (in particular) any land, house, or other building, plant, machinery, vehicle, vessel, apparatus or equipment; or

(b) any computer software; "relevant asset" means any asset apart from housing land; and "works" means any works consisting of the construction, enhancement, replacement or installation of an asset, apart from works consisting of the construction of a house or other dwelling on housing land.

(2) For the purposes of this Part, a transaction is a private finance transaction if

(a) the consideration received by the Authority under the transaction includes-

(i) the provision or making available of a relevant asset or the carrying out of works for the purposes of, or in connection with, the discharge of a function of the Authority; and

(ii) the provision of services for the provision of, or in connection with, the discharge of the same function;

(b) the Authority do not give to any other person any indemnity or guarantee in respect of any liabilities of the person with whom they enter into the transaction (whether those liabilities are incurred in respect of the transaction or otherwise);

(c) the consideration given by the Authority under the transaction includes the payment of fees by instalments at annual or more frequent intervals;

d) the fees are determined in accordance to factors which in every case include-

(i) standards attained in the performance of the services; or

(ii) the extent, rate or intensity of use of the relevant asset, or, as the case may be, of the asset which is constructed, enhanced, replaced or installed under the transaction; and

(e) the first instalment of fees falls to be paid after the services have started to be provided."

<u>The New Regulation 40 – effective from 1 April 2000</u>

40(1) A credit arrangement which is a private finance transaction shall be excluded from section 49(2), and the initial cost and the cost at any time of the arrangement shall be nil, if the authority determine that in accordance with proper practices no item, other than an item specified in paragraph (2), is required to be recognised as an asset in any balance sheet they are required to prepare in accordance with such practices for the financial year in which the credit arrangement comes into being with respect to property which is either:

(a) provided or made available under the transaction; or

(b) constructed, enhanced, replaced or installed under the transaction.

(2) The following items are specified for the purposes of paragraph (1):

(a) any item relating to a contribution by the authority of an asset to any person with whom they enter into the private finance transaction in return for a reduction in the consideration payable by the authority to that person under the transaction; or

(b) any item relating to an asset to be provided or made available under the private finance transaction by any person which is transferred into the ownership of the authority, whether or not upon payment of any consideration by the authority, at the end of the contract term relating to the transaction.