Dough for The Doughnut: The Private Finance Initiative

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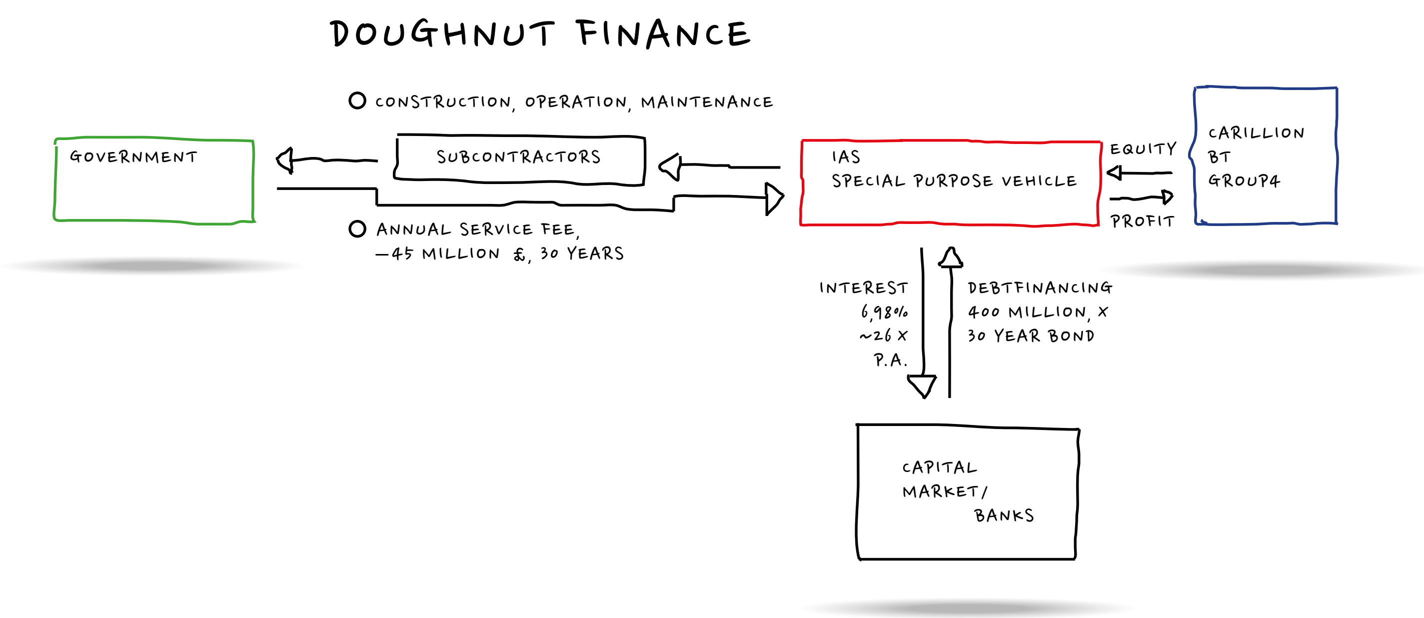

The dough for 'The Doughnut' didn't come directly from the taxpayer. It might be surprising, but the British Government does not own the new Government Communications Headquarters (GCHQ) building. The Doughnut was built under a controversial scheme known as the Private Finance Initiative (PFI). It was financed by IAS, a consortium of private firms that raised the 400 million pounds needed for its construction in one of the largest PFI projects undertaken in Britain in the 2000s.[1]

In conventional public building projects, the government finances the construction of its facilities and it owns and operates them. But under PFI projects, the government outsources the construction and then pays an annual service fee to the private-sector consortium that built the structure for profit. In the case of The Doughnut, the government leases the building in Cheltenham over a 30-year period for an annual service charge of about 45 million pounds from the construction consortium.[2] The annual service fee covers the costs of construction and operation as well as the profits of the special purpose (SPV) that the participating companies have set up to finance and operate the building.

Before the 2007–08 financial crisis, such PFI contracts were frequently used as an alternative to traditional public funding. While the original motivation was to save taxpayers' money through more efficient private-sector service delivery, PFI projects were, with few exceptions, financially bad ideas that cost the British taxpayer dearly. The short history of the PFI offers a fascinating tale about how, in an ideological drive to promote private-sector involvement in public infrastructure projects, cost efficiency and sound financial accounting were ignored, and mounting public expenditure effectively hidden from the public.

The History of a Bad Idea

The PFI was launched in 1992 by the Conservative government of John Major. After coming to power in 1997, 'New Labour' under Tony Blair enthusiastically embraced it as a means to mobilise private capital to meet the infrastructure needs of the country. Until 2010, capital investments costing more than 60 billion pounds have been carried out by PFI investors, most of them in the health and transport sectors, as well as in defence. The (discounted) value of the financial obligations of the public sector from these PFI contracts is about 150 billion pounds, in nominal terms well over 250 billion.[3] By 2012, the financial obligations of the public sector from PFI projects have risen to above 300 billion, and annual service payments to private service providers will reach 10 billion in the coming years.[4]

However, since the inception of the PFI, its economic logic has been the subject of public and academic debate: does it make financial sense to use private capital for public infrastructure projects? Does PFI offer value for money for British taxpayers, or just high profits for construction consortia that can generate enormous returns on capital through high leverage?

In 2011, the Treasury Committee of the House of Commons undertook a comprehensive review of PFI projects. It reached a damning conclusion:

> The price of finance is significantly higher with PFI. The financial cost of repaying the capital investment of PFI investors is therefore considerably greater than the equivalent repayment of direct government investment. We have not seen evidence to suggest that this inefficient method of financing has been offset by the perceived benefits of PFI … On the contrary there is evidence of the opposite.[5]

The Economics of PFI

For economists, the Treasury Committee's negative assessment of the PFI wasn't surprising. The idea that the private sector had an advantage in providing capital-intensive infrastructure was always an offence to basic economic logic. The flaw in the financial rationale of PFI is the following: by definition, infrastructure investment projects require significant capital. The price of capital, i.e. the interest rate at which funds can be raised in financial markets, is therefore a crucial factor for the viability of projects.

Yet when it comes to borrowing, the government enjoys a distinct advantage over the private sector: it can raise money at much lower interest rates than any private company. The upshot is that for a privately run infrastructure project, capital costs – the single largest cost item – will always be significantly higher than for the government. Or, put differently, the government gives up its financial edge with capital markets. This leads automatically to higher capital costs.

The Doughnut's construction history nicely illustrates this fundamental flaw in PFI logic. The interest rate that IAS (the private consortium) had to pay to borrow the 400 million needed for the construction of the building was 6.48% for 30 years – about 40% higher than the corresponding rate the government would have had to pay (4.68%).[6] And this was even a relatively good deal. On average, the premium that private investors had to pay on other PFI deals was an additional 2.25% of annual interest. What's more, under PFI these higher-interest costs are passed back to the government through the 'service fee', which includes, among other costs, interest charges that are higher than they would have been had the government chosen to take the construction into its own hands.

Value for Money?

Against this background, how was it possible, then, that so many PFI projects passed the Treasury's own value-for-money test? With the benefit of hindsight, many of them shouldn't have. The conclusion that PFI offered value for money could only be reached under strong assumptions about cost savings that the private sector could achieve in other areas. In practice, the standard justification was that under government construction and management there would always be significant cost overruns that could be avoided under private operation.

For instance, in the case of The Doughnut, it was simply assumed that under the public financing option the construction costs would be 24% higher, resulting in total costs of more than 500 million pounds instead of 400 million under PFI. The Doughnut was no exception, but typical of the assumptions underlying PFI projects. A presumed public-sector inefficiency in the form of cost overruns was supposed to compensate for the higher financing cost of private investors. Without this hypothetical adjustment, the public sector alternative would have been considerably cheaper.[7]

But the evidence on which these assumptions were based was very thin. In its 2011 review, the Treasury Committee found no indication that such automatic adjustments were justified. The MPs found that the costs of construction and service provision are broadly similar between PFI and government-procured projects. The Committee therefore concluded: 'We have not seen clear evidence of savings and benefits in other areas of PFI projects which are sufficient to offset the significantly higher cost of finance'.[8]

Ideology and Interests

If the underlying economic rationale for PFI is dubious, how can one explain its immense popularity in British politics in the 2000s? Ideology and interests both played a role. The emphasis on the efficiency of private-sector finance meshed well with the neo-liberal zeitgeist. The belief that the dynamism of unfettered markets, financial and other, could be used to promote the greater social good underpinned the 'Third Way' of politics that the sociologist Tony Giddens proclaimed in the late 1990s.[9] And it is not difficult to find in the PFI agenda elements of the central neo-liberal tenet that, as Stuart Hall puts it, 'state-led "social engineering" must never prevail over corporate and private interests'.[10]

What is harder to understand, however, is the way that PFI effectively exceeded the pro-market agenda of the neo-liberal 'revolution' that initially focused on opening sectors to private competition where the government arguably had no distinct advantage in providing the services (think telecoms or television). In the 2000s, the private-can-do-better approach became an ideological mantra in British politics. Through PFI, it was even applied in areas where the very economic efficiency logic that stood at the heart of the neo-liberal agenda suggested otherwise. Neoclassical economics, the intellectual foundation of the neo-liberal creed, made it clear that government's ability to borrow at risk-free rates posed a high hurdle to the outsourcing of long-term infrastructure investment to the private sector.

In this way PFI neo-liberalism was squared — an attempt to construe a case for the privatisation of public services and the involvement of private finance even in circumstances where the private sector was at a financial disadvantage. It thereby violated rule number one of the neo-liberal gospel: economic efficiency logic was pushed aside in favour of ideology. Increasingly lofty financial assumptions and ultimately higher costs for the taxpayer were the consequences.

However, ideology only goes half way to explaining the popularity of the PFI agenda. Interests account for another important part of this story. In a disturbing coincidence, both temporal and conceptual, the rise of PFI can be seen as the public sector equivalent of the rise of shadow banking. Before the global financial crisis, the world's big banks used affiliated 'shadow banks' to hide the true extent of their leverage from financial regulators. In a similar fashion, British Government agencies used PFI to hide the true extent of public liabilities from the public. PFI opened the door to financing public expenditure off the books. According to a 2009 report by the National Audit Office, 78% of all PFI projects were 'off-balance sheet'. For PFI projects initiated by local governments the share was a stunning 95%.[11]

The House of Commons Committee also left no doubt that 'the incentive for government departments to use PFI to leverage up their budgets, and to some extent for the Treasury to use PFI to conceal debt, has resulted in neglecting the long term value for money implications'.[12]

This was possible because on paper, the owners and operators of PFI-financed buildings like The Doughnut were private and the government merely signed a long-term service contract. The fact that the service contract would run for 30 years and obliged the government to repay the entire capital investment of the private consortium did not change the accounting treatment under international rules: 'service fees' did not have to be reported as public-debt service obligations or be explicitly added to the public debt. PFI therefore opened an attractive way to conceal public expenditure and hide mounting public debt. The accounting loophole was closed after 2009.

PF2

After the critical report of the Treasury Committee and prominent bankruptcies of PFI projects such as the failure of the Metronet consortium in charge of overhauling the London Tube, the public image of the PFI was so tarnished that the newly elected Conservative government of David Cameron decided to stop the PFI programme. In late 2012, it relaunched a modified successor programme, called 'PF2'.[13] The main innovation of the PF2 programme is to increase transparency and make the taxpayer a shareholder in the projects so that some of the financial upside can be captured by the government.

Yet the damage to the 'PF'-idea was done. Industry observers note a 'distinct lack of buzz' to engage in PF2 projects.[14] Public opposition to PF-style projects, in particular inside the National Health System, has grown after a number of NHS trusts struggled under the mounting costs of PFI contracts.[15] The days of large-scale PFI-type projects are probably behind us, both in the United Kingdom and other countries. The main reason is that financial terms have become less attractive after the financial crisis. Yet overall this is good news for the British taxpayer, although the financial burden from past PFI-projects will continue to rise for some time.

Yet one cannot ignore a deeper irony here. The Doughnut was not only financed by private investors as part of a political agenda that distrusted the government to make sensible investments even in areas where it enjoyed a clear financial edge over the private sector. The ultimate motivation to use private funds to pay for the new headquarters may well have been that the PFI-option allowed the government to leave the public in the dark about the full financial implications. Leaving the public in the dark appears to be part of the DNA of the entire project. *Honi soit qui mal y pense*.[16]

1. The consortium consists of the construction company Carillion, the security company Group 4, and British Telecom.
2. National Audit Office, *Government Communications Headquarters (GCHQ): New Accommodation Programme, Report by the Comptroller and Auditor General, HC 955 Session 2002–2003: 16 July 2003*.
3. House of Commons, Treasury Committee, *Private Finance Initiative, Seventeenth Report of Session 2010–12*
4. Simon Rogers and James Ball, 'PFI contracts: the full list', *The Guardian*, http://www.theguardian.com/news/datablog/2012/jul/05/pfi-contracts-list (last accessed 31 October 2015).
5. House of Commons, op cit, p.3.
6. National Audit Office, op cit.
7. Ibid.
8. House of Commons, op cit.
9. Stuart Hall, 'The Neo-liberal Revolution', Cultural Studies 25, no. 6, 2011, pp.705-28.
10. Ibid, p.707.
11. National Audit Office, *Private Finance Projects, A Paper for the Lords Economic Affairs Committee*, October 2009, p.37.
12. House of Commons, op cit, p.35.
13. HM Treasury, 'A new approach to public private partnerships', December 2012.
14. Industry grows impatient as PF2's teething problems persist', *Financial Times*, 29 April 2014.
15. 'The PFI hospitals costing NHS £2bn every year', *The Telegraph*, 18 July 2015.
16. *May he be shamed who thinks badly of it*.

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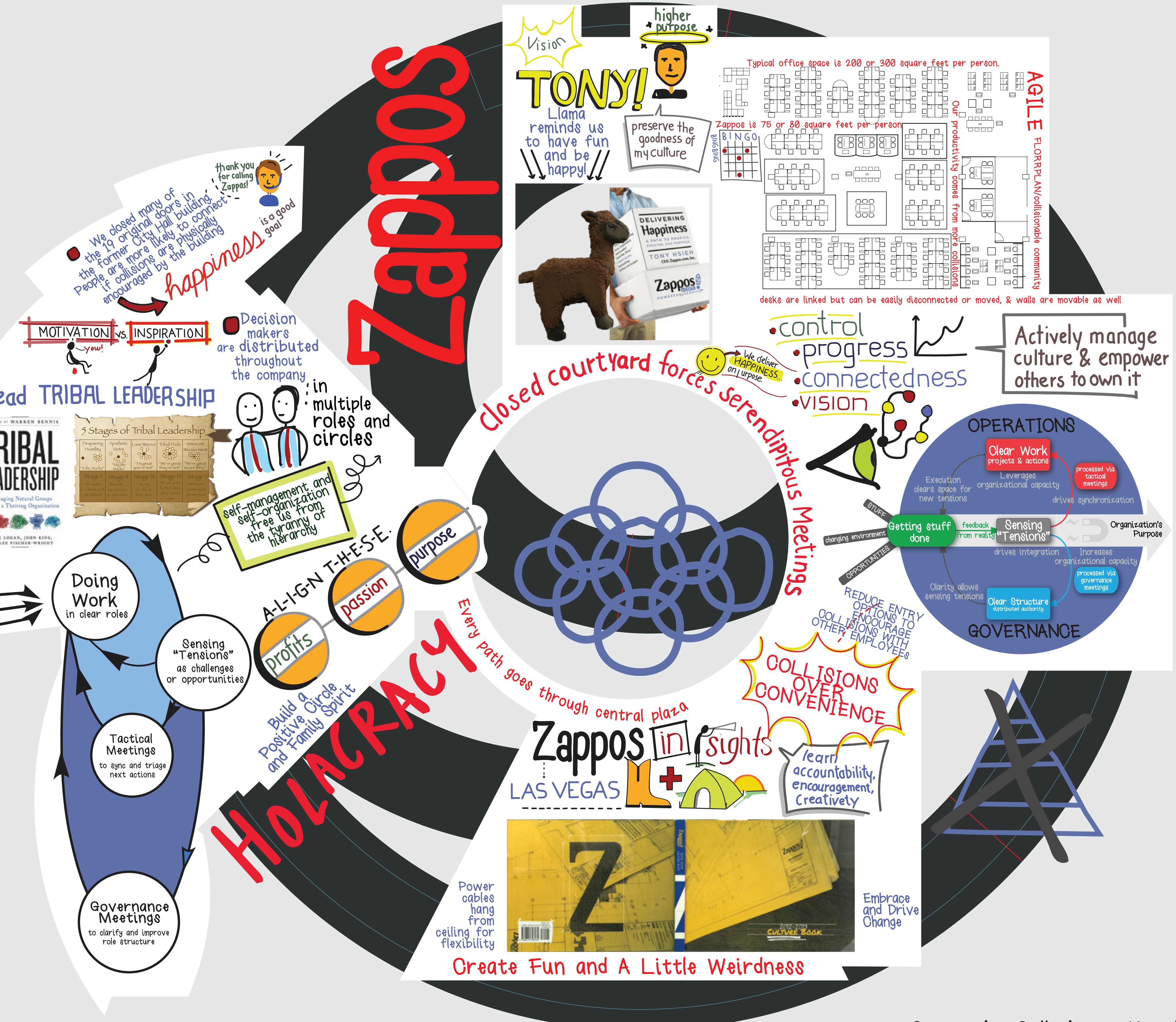

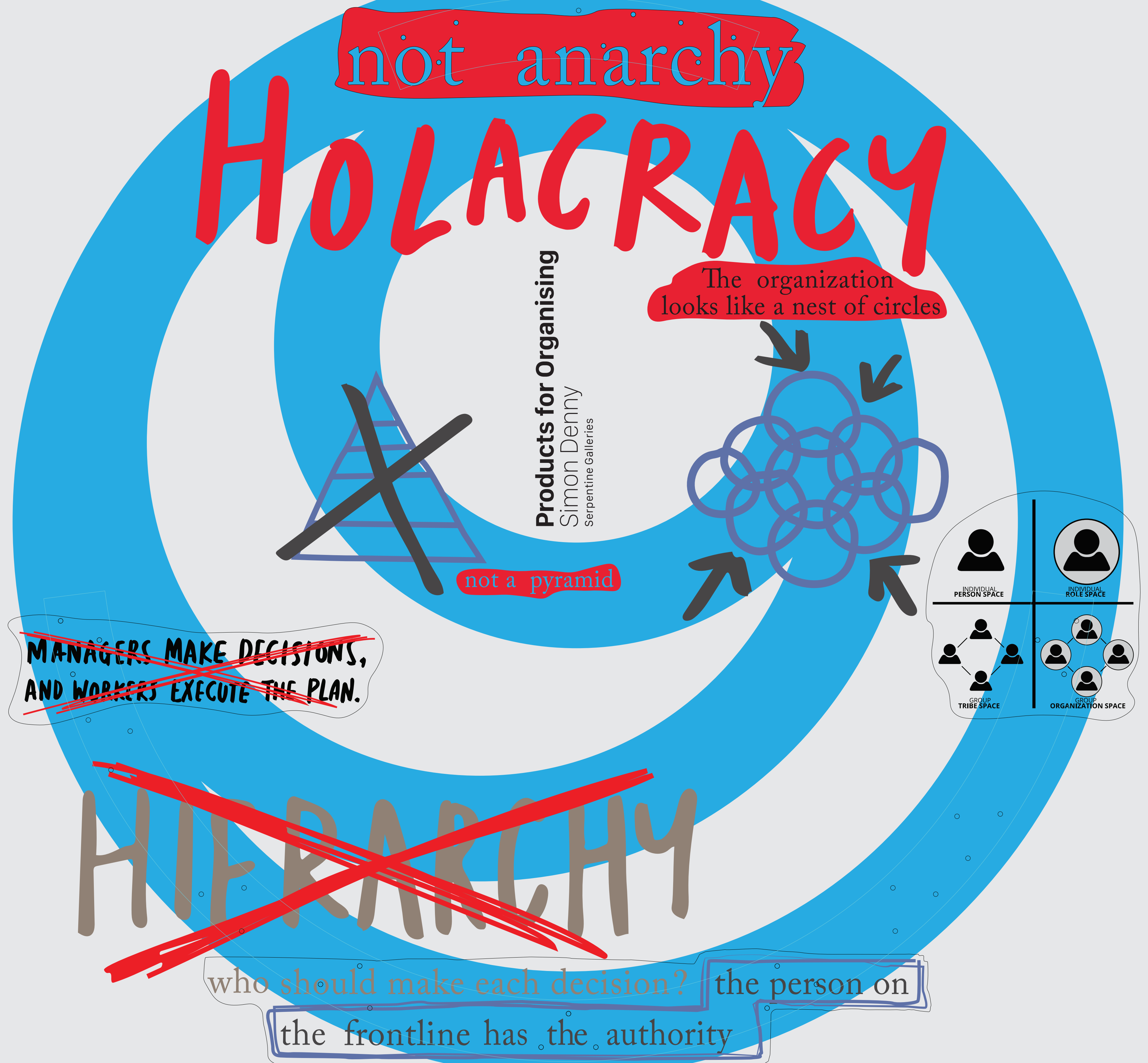

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