

The UK's PPPs Disaster

Lessons on private finance for the rest of the world



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1. Introduction: The background to PPPs in the UK

PPP deals are “a millstone round the necks” of London hospitals.¹

Sadiq Khan, Mayor of London

“Large fiscal costs and fiscal risk have arisen from PPPs in both developing and advanced countries ... government bias and possible manipulation of PPPs add an important layer to the common project risks. An inadequate budgetary and/or statistical treatment may allow governments to ignore the impact of PPPs on public debt and deficit. In practice, governments often end up bearing more fiscal costs and risks than expected in the medium and longer term.”²

IMF Working Paper, Fiscal Affairs Department

A ‘Public Private Partnership’ (PPP) is a type of contract under which private companies build and operate public services and infrastructure, but much of the financial risk remains with the public body concerned. The World Bank, as of December 2016, lists 92 countries as having passed laws enabling or related to PPPs.³

One of the first countries to develop PPPs was the UK, where they are known as the Private Finance Initiative (PFI). PPPs began in the UK in 1992, but expanded from the late-1990s across all parts of public spending including healthcare, education and the military (see Graph 1 below).

Under PPPs in the UK, the government pays to use infrastructure designed, financed, built, owned and operated by a consortium of private financiers and providers, until ownership usually passes to the government, on completion of payment, several decades later.

PPPs transformed public infrastructure from a public good into an investment ‘asset class’ enabling banks and private equity investors to extract wealth from the public sector, via contracts underwritten and enforced by the government.

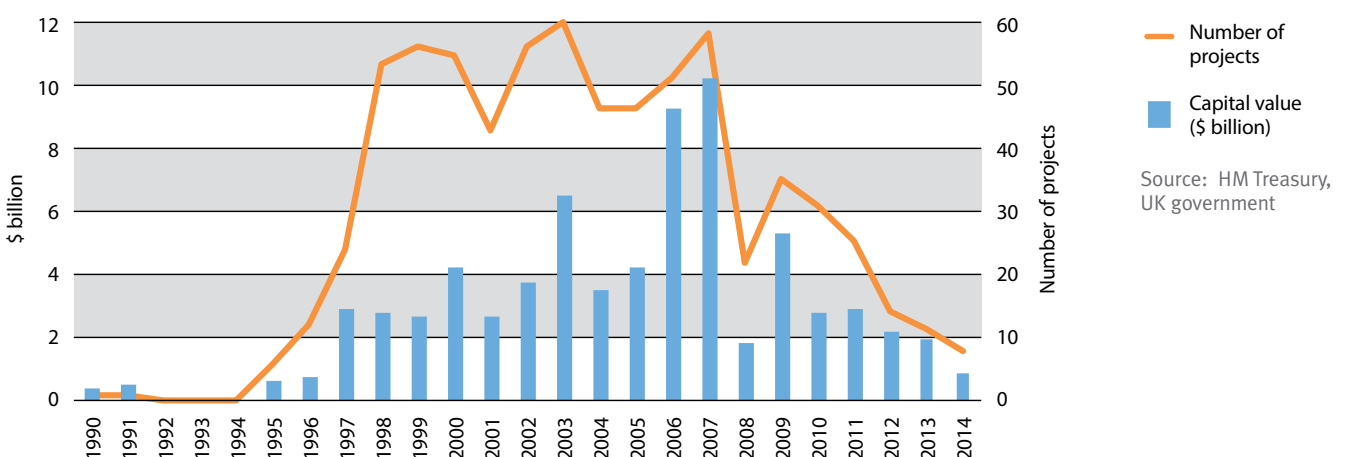
This briefing sets out the major problems and risks the UK has encountered through its extensive experiment with PPPs, including how they have:

- Cost the government more than if it had funded the public infrastructure by borrowing money itself
- Led to large windfall gains for the private companies involved, at public expense
- Enabled tax avoidance through offshore ownership
- Led to declining service standards and staffing levels
- Hollowed out state capacity to design, build, finance and operate infrastructure
- Eroded democratic accountability

PPPs are hugely unpopular in the UK, with 68% of respondents to a survey in England saying PPPs should be banned.⁵ In Scotland, which has a higher proportion of projects per person, 76% of respondents say they should be banned. This unpopularity has led to PFI being rebranded in both England and Scotland (see section 5 on page 7).

The number and value of new projects has been falling since 2008, reaching its lowest level since the mid-1990s in 2014 (the latest year with figures available). However, the UK government and companies are now heavily promoting PPPs around the world. This briefing sets out the real story of PPPs in the UK, with the hope of better informing interested and affected parties in other countries around the risks and costs involved in PPPs.

Graph 1: UK PPP Contracts 1992–2015⁴



2. The financial impacts of UK PPPs

“One of my biggest concerns is that many of the hospitals now facing huge deficits are seeing their situation made infinitely worse by PFI debt.”⁶
UK Health Minister, Jeremy Hunt MP, speaking in 2015

PPPs cost governments more and create hidden public debt

Proponents of PPPs in the UK claimed they would lead to more private investment without increasing public sector borrowing figures – an attractive prospect for governments. PPPs in the UK have delivered new public infrastructure, funded by banks and other financial institutions rather than directly by government bodies. Such PPPs are therefore deemed ‘off balance sheet’ for accounting purposes, giving the impression of prudent financial management. However, the relevant government body still has to make annual payments to the private companies involved, just as it would have to make debt payments if it had borrowed directly to build infrastructure.

The hidden cost to the public sector is that the interest rates payable on PPPs in the UK have been twice as expensive as on UK government borrowing.⁷ This means that PPPs cost the taxpayer far more than if the government had borrowed to fund projects itself. In addition to the higher interest costs are the transaction costs to pay accountancy and legal firms to arrange the deals, and the high profits the private companies which invest equity in PPPs demand.⁸

The IMF note: *“Instead of government making upfront payments to cover the cost of building an asset, the private sector bears this cost and government covers the opportunity cost of capital as part of its service payment to the private sector. This is how PPPs can be used to record initially lower government borrowing and debt than with traditional public investment.”*⁹

The IMF warn: *“PPPs can be used mainly to bypass spending controls and move public investment off budget and debt off the government balance sheet, while the government still bears most of the risk involved and faces potentially large fiscal costs.”*¹⁰

This has been the case in the UK. Since 1992 PPPs yielded public assets with a capital value of \$71 billion.¹¹ The UK government will pay more than five times that amount under the terms of the PPPs used to create them.¹² In some cases, like the Edinburgh Royal Infirmary hospital,¹³ the government will never own the asset, because the PPP is a leasing agreement.

The average interest rate currently paid by the private providers of PPP projects is 8%, whereas the UK government can borrow for 30 years at 3.5%. In 2011 a review by the UK parliament’s Treasury Committee found that *“The use of PFI has the effect of increasing the cost of finance for public investments relative to what would be available to the government if it borrowed on its own account.”*¹⁴ A 2015 review by the UK National Audit Office, the independent public body responsible for investigating government accounts, found that investment through PFI schemes more than doubles a project’s cost to the public sector.¹⁵

The UK parliament’s Treasury Select Committee review of PFI in 2011 did not see *“any convincing evidence that savings and efficiencies during the lifetime of PFI projects offset the significantly higher cost of finance.”*¹⁶ The Committee continued: *“PFI funding for new infrastructure, such as schools and hospitals, does not provide taxpayers with good value for money and stricter criteria should be introduced to govern its use.”*¹⁷

The National Audit Office also observed PPP finance costs increased between 2008 and 2015 despite the fact that interest rates on UK government debt were steadily falling over the same period: *“The case for using private finance in public procurement needs to be challenged more, given the cost of debt finance increased since the credit crisis by 20 per cent to 33 per cent.”*¹⁸

Consultants add to the cost of PPPs

Four major accountancy firms – PWC, KPMG, Ernst & Young and Deloitte: known as the ‘Big Four’ – have dominated PPP consulting in the UK. One firm advises on government procurement, another advises the PPP consortium of banks and construction firms.¹⁹ Other large transactions costs include those of law firms working on the deals.

The European Investment Bank found ‘transaction costs’ for PPP deals have ‘not received much attention’, yet amount to ‘well over 10% of total project capital value.’²⁰ Testimony from Richard Abadie from PWC to the UK parliament’s Treasury Select Committee suggests PWC charge \$312,500 – \$500,000 in advisory fees for school PPP projects and \$625,000 – \$1,000,000 per hospital.²¹

High, fixed transaction costs (legal and advisory fees) on PPP contracts contribute to a trend towards larger, more complex projects²² and longer procurement timeframes.²³ Increasing size and complexity in PPP infrastructure projects – said to be a sign of corruption in developing countries²⁴ – is observable within UK PPP

projects, such as St Bartholomew's Hospital, which cost \$1.4bn to build, but will cost UK taxpayers \$9.1 billion.²⁵

The financial risk remains with the government

Higher costs of PPP finance are justified on the basis that risk is 'transferred' from the public to the private sector. Yet in reality the private sector has insisted on government guarantees which ensure all the risk is borne by the public. Speaking in London in November 2015, former UK Finance Minister and Prime Minister Gordon Brown, who oversaw much of the PPP programme in the UK, said: *"the private sector try to transfer all the risk of PPPs back to public sector, as we found to our cost in the UK with PFI schemes."*²⁶

The IMF observe: *"Government guarantees provided in connection with PPPs are a major source of fiscal risk ... Most commonly with PPPs, [private sector] financing risk is reduced through loan guarantees, demand risk is reduced through guaranteed minimum payments for services sold to the public, residual value risk is reduced by government guaranteeing a price at which it will purchase an asset when the operating contract ends."*²⁷

Equity investors have made windfall gains

UK PPPs are initially financed by banks and private equity, which demand a 'risk premium' during the construction phase to offset potential losses – for example, the risk that a construction firm will go bankrupt and the asset will not be built. Once construction is completed and construction risk evaporates, the PPP consortium refinances the project, at lower rates of interest, with ownership shares transferring to pension funds and long-term institutional investors, requiring stable low-risk returns.

Refinancing 12 PPP projects between 1999–2005 resulted in a \$178.25m gain for companies involved, compared to just \$34.1m for the public sector. The public sector is left effectively paying high interest rates, while the companies benefit from lower interest rates following refinancing. This in turn enables the private sector to increase the profitability of PPPs, over and above the average 14.5% internal rate of return that is built into projects before refinancing.²⁸ At Norfolk and Norwich Hospital, PPP refinancing created a windfall gain of \$145 million²⁹ for the private contractor.

PPPs enable tax avoidance through offshore ownership of public assets

As exposed by the European Services Strategy Unit,³⁰ PPP refinancing means infrastructure funds and other investors, commonly located offshore in tax havens, can own, control, and sell on UK infrastructure virtually tax-free.

Margaret Hodge MP, former Chair of the UK Parliament's Public Accounts Committee, the Parliamentary body responsible for scrutinising UK public spending, called the resale of PPP contracts: *"a total scandal – we've all been ripped off ... I'm afraid we got it wrong. I was a supporter at the time but I have completely gone off the whole concept. We got seduced by PFI."*³¹

Hodge added it was "scandalous" that many of the funds buying up the contracts are based in tax havens. One of the early arguments in favour of PFIs was that taxpayers would benefit from contractors' profits due to the corporation taxes they would pay. *"But profits are going offshore and to shareholders."*³²

In 2011, the Public Accounts Committee warned that investors made bumper profits from taxpayers by buying up contracts for schools and hospitals funded through PPPs, taking the proceeds offshore. The committee criticized the UK Treasury for assuming PPP contractors would pay tax, when many are based in offshore tax havens.³³ It concluded: *"Government should revisit tax assumptions it builds into the cost /benefit case for PFI. It assumes Government tax revenue from PFI investments, but one of the largest PFI investment funds told us 72% of shareholders are registered offshore"*.³⁴

Former tax inspector Richard Brooks, who left the UK government's tax collector HMRC after the tax department signed a PPP deal with Bermuda-based property investment company Mapeley Steps³⁵ said: *"All told, by 2012, over 200 PFI companies were partly owned offshore, more than 70 of them running health service projects. By my calculations, 168 state schools, many of which are run under a single PFI contract are at least partly owned offshore. That so many public assets are shunted into offshore tax havens is a remarkable outcome."*³⁶

3. Other negative impacts of UK PPPs

“Every penny paid to a PFI company is money withdrawn from those waiting for an operation, money removed from the training of clinicians, and money denied for life-saving treatments. Much of the PFI debt is now owned offshore, to avoid paying tax on the profits generated from the taxes you and I pay. Huge profits from public money are being made by tax dodgers.”³⁷

Leader of the official opposition in the UK, Jeremy Corbyn MP

Ownership and control of public infrastructure has profound political, social and financial implications for public service provision and democratic accountability. PPPs result in a profit-driven, market logic within public service provision and the creation of an increasingly corporatised public service management layer. Considerations such as public safety and satisfaction are subordinated to meeting contractual repayments to PPP providers.

Financial pressures of PPPs drive declining service standards and staffing levels

As a result of PPPs, staffing levels and service standards have declined in the UK as spending on variable costs (staffing and services) are reduced to meet inflation linked debt repayments. Allyson Pollock, an academic focused on the UK's National Health Service (NHS) observes: *“There is no evidence PFI increased overall levels of service. On the contrary, its use in the NHS had two main effects. It has displaced the burden of debt from central government to NHS trusts, with it the responsibility for managing spending controls and planning services, thereby hindering a coherent national strategy. Secondly, the high cost of PFI schemes presented NHS trusts with an affordability gap. This has been closed by external subsidies, diversion of funds from clinical budgets, sales of assets, appeals for charitable donations, and, crucially, by 30% cuts in bed capacity and 20% reductions in staff in hospitals financed through PFI.”*³⁸

PPP repayments are ‘ring-fenced’, meaning that once a contract is signed, it is extremely difficult to renegotiate or trim costs. Public authorities are forced to reduce staff numbers and levels of services as repayments increase and budgets come under pressure.

Nigel Edwards, head of policy for the UK's National Health Service Confederation, notes: *“A hospital with a PFI scheme [is] contractually bound to keep maintenance up, and spending 10–15% on your buildings means all*

*the other efficiency and productivity gains you need have to come out of only 85–90% of your budget.”*³⁹

PPPs hollow out state capacity to design, build, finance and operate infrastructure

The UK government now has less ability to design, build, finance and operate new public infrastructure because PPPs have meant less of a role for the public sector for the last 15 years. Dexter Whitfield of the European Services Strategy Unit finds the long-term impacts of PPPs for society and workers in the UK public sector include:⁴⁰

- Decline in public sector employment
- Decline of in-house public service delivery as services are transferred to the private sector
- Reduced capacity of public sector due to reduced knowledge transfer
- Bigger private sector role in regeneration and management of public sector assets

Erosion of democratic accountability

PPPs erode democratic accountability in public service delivery, with increasing restrictions on community organisations and staff/trade union consultation and involvement in planning, business case development and procurement.

The complex, technical nature of PPPs impose professional barriers on participation – financial, legal, technical – meaning that key stakeholders, including user groups, are excluded. PPPs lead to consultants and advisers adopting a very influential role with little accountability or public scrutiny.

‘Commercial confidentiality’ also makes access to PPP contracts and comparisons between public and private sector performance almost impossible, as information on quality and level of service, staffing levels, pay and conditions and other factors which determine performance is extremely difficult to obtain from PPP contractors.

PPP contracts are inflexible

In numerous cases PPP facilities now sit empty after cuts to public services. But the terms of the PPP contract mean the government still has to make decades of repayments for buildings, which cannot be converted to other uses due to the strict terms of the contracts. Cases include:

- Weymouth East Police Station in Dorset which, while empty, is costing local police \$2.63 million a year in fees and charges, enough to hire a further 60 police officers.⁴¹
- A Belfast PPP school which closed after seven years, where the contractor must be paid \$462,500 a year for the next 16 years for the unused and empty facilities.⁴²

4. Individual PPP case studies

Education: Edinburgh Schools Partnership

Scotland has higher per-capita expenditure on PPPs than any other UK region.⁴³ In education PPPs, UK parliamentarian Stella Creasy notes: “Scotland has 40% of PFI schools, with just 8.5% of the [UK] population.”⁴⁴

The social and financial costs of PPP projects to Scotland emerged in Edinburgh in March 2016 when the brickwork facade of Oxgangs primary school collapsed during a storm. Usually a busy play area for children, only the

good fortune that the collapse occurred over a weekend prevented serious injuries.

The construction firm on the Edinburgh Schools Partnership – Miller Construction – was allowed to “self-certify” that buildings met local authority building safety standards, without building inspectors visiting the site to observe the work. In their haste to complete the project and minimise costs, builders forgot crucial wall ties needed for the building’s structural integrity. After the building collapsed, authorities carried out urgent safety inspections across Edinburgh, resulting in 17 PPP schools being closed to students due to structural faults identified by inspectors.

Edinburgh Schools Partnership issued a statement deeming Miller Construction’s work “unacceptable”. It said: “The standard of building work carried out by Miller Construction is completely unacceptable and we are undertaking full structural surveys on all PFI schools to determine the scale of the problem.”⁴⁵ In response to the Oxgangs school collapse, Scottish First Minister Nicola Sturgeon MSP said: “The priority is to get children back to school ASAP and give parents all necessary assurances” but “questions must be asked, and in due course answered, about old PFI contracts that many feared put profits before quality.”⁴⁶

Health: Calderdale Royal Hospital

Calderdale Royal is a hospital built through a PPP in the West Yorkshire region of northern England between 1998 and 2001. The initial cost of the hospital was expected to be \$42.5 million but this almost doubled to \$81 million by the time it was built.⁴⁷ The deal was negotiated by the Conservative government of the 1990s and agreed by the Labour government in 1998.

Under the terms of the contract, the local health service has to pay \$390 million over 30 years to the private company to cover debt principal and interest payments.⁴⁸ In contrast, if the government had borrowed the money directly, with an interest rate at the turn of the millennium of 5%, the total cost over 30 years would have been \$159



Photo: Wullie Marr / Deadline News

The collapse of the brickwork façade of Oxgangs primary school in Edinburgh in March 2016.

million.⁴⁹ The hospital cost \$231 million or 150% more than it should have done. Another hospital and a half could have been built instead.

So far, the PPP contract has changed hands ten times, though it is not known how much money has been made each time it has been sold on.⁵⁰

The local health service also has to pay a charge every year for building and maintenance services. This totals \$576 million over 30 years, bringing the total cost to \$966 million.⁵¹ Local Conservative MP Jason McCartney has called the PPP deal “scandalous”⁵² whilst local Labour MP Barry Sheerman has said: “*What sort of a deal was it when a relatively standard hospital was built but then left with enormous long term debt. Who are these sharp people from the city in suits that have run rings round the hospital trust when it was constructed?*”⁵³

The huge payments for Calderdale Royal have contributed to a funding crisis for the local health service, which covers both Calderdale Royal Hospital and Huddersfield Hospital, because the money given to the local hospitals by the UK government is not enough to cover all the payments. In response, the decision

has been taken to close one Accident and Emergency Department from the two hospitals. Furthermore, because the local health service is legally obliged to make the high payments to use Calderdale Royal, it has chosen to close the Accident and Emergency at Huddersfield Hospital instead. 130,000 local people have signed petitions against the Accident and Emergency closure,⁵⁴ with widespread demonstrations.

The PFI contract has a break clause in it after 30 years, by when all the debt and interest will have been paid, which allows the local health service to escape the huge service charges. However, if the break clause was used the hospital and land would remain owned by the private company and a one-off \$28 million fee would have to be paid.⁵⁵ If the break clause is not triggered, the contract will continue for another 30 years, with high service charge payments continuing. Only after 60 years will the hospital come to be owned by the public sector.

Calderdale Royal Hospital PPP has both increased costs for healthcare for the UK government, and forced a reduction in local health services in the area. Even when the expensive deal finishes, ownership of the hospital will remain with the private company, rather than being transferred to the public sector.

5. A change in the UK’s approach?

The UK has made two attempts to introduce new infrastructure models to replace PFI following its widespread criticism. The Non-Profit Distributing (NPD) model, from 2007 in Scotland, and PF2 in England and Wales from 2012. However, neither model adequately addresses fundamental flaws of PPPs, namely expensive private finance, and costly, inflexible private service provision.

Non-Profit Distributing (NPD) Model – Scotland (developed by Scottish Futures Trust)

The NPD infrastructure model was the Scottish National Party (SNP) alternative to PFI, which the SNP had strongly criticised in the run-up to gaining power from the Labour party in the 2007 Scottish elections.

NPD was conceived by the Scottish Futures Trust to replace PFI as a vehicle that “*could design, build, finance, operate, manage and own the facilities created. An all-singing, all-dancing national public investment company.*”⁵⁶

Instead, the Scottish Futures Trust became co-ordinator between the government and the private sector, employing a revised version of PPPs, which removes the expensive private equity finance component. Edinburgh University PPP expert Dr Mark Hallowell is critical of NPD stating that it maintains the high debt cost of PFI, and so means PPPs in Scotland are still very expensive for the public sector.⁵⁷

PF2 – England and Wales

PF2 was announced in December 2012 by the UK government as a replacement for PFI in England and Wales, hailing a “*new approach to public private partnerships.*”⁵⁸ Again, it was introduced by a new government, this time the Conservative and Liberal Democrat coalition, which replaced the Labour government in 2010. Both parties had previously been critical of Labour’s use of PPPs.

In reality, PF2 does little more than rebrand PFI. Slightly more of the investment is expected to be undertaken through equity rather than debt, which is likely to

increase costs to the public sector because rates of return on equity are higher than the interest rate on debt. Though the government is also intending to invest equity itself, which will reduce costs to the public sector.

Hexham PFI Contract Buyout

The disastrous experience of PPPs in the UK means that some projects have been taken back into public hands in order to mitigate negative impacts and the cost to the public sector.

In 2014, Northumbria NHS Trust, the public body responsible for health services in that region of England, borrowed \$142.5 million⁵⁹ from the local authority to pay off the private contractors which built and ran Hexham General Hospital through a PPP. Built for \$63.75m, under the terms of the 32 year PPP contract, repayment costs would have totalled \$311.4m by the end of the contract in 2033.

The \$142.5m borrowed compensates the private PPP company while saving the trust \$83.8m⁶⁰ or \$4.4 million per year for 19 years.⁶¹ The UK Government imposed strict terms that the PPP consortium would be repaid in

full for the remainder of the contract. Despite this, the public sector saved money through the buyout because interest rates on UK government debt are lower than typical PFI rates of 7–8%.

The Isle of Skye Toll Bridge Buyout

The toll bridge linking the Isle of Skye to the Scottish mainland was the first UK PPP project constructed. Unlike typical UK PPPs, the operators were repaid exclusively via toll income, not through government repayments.

The bridge was opened in 1995 at a capital cost of \$48.8 million.⁶² Very high tolls to use it (\$14.25 for a 1km return journey by the year 2000) led to a decade of protests by enraged locals, over 500 arrests, and 130 members of the community prosecuted and jailed for refusing to pay the excessive toll.⁶³

In December 2004, the Scottish Government was forced to scrap the tolls, buying the bridge from Bank of America for \$33.8 million. As well as the buyout payment, in the time that it owned the bridge, the contractor collected \$41.6 million in tolls, against running costs of \$4.4 million.⁶⁴

6. Conclusion

PPPs in the UK have delivered public infrastructure with a capital value of \$70.6 billion. But this has not come for free. The government is committed to paying much more to use the infrastructure than if it had borrowed the money itself. Furthermore, some poor quality PPP infrastructure is already collapsing, as in Edinburgh. Through PPPs, public assets are now controlled by offshore investors located in tax havens.

PPPs reflect the assumption that corporate financial interests and the public interest are synonymous. Jean Shaoul, Professor at Manchester Business School says PPPs in the UK have been “*an enormous financial disaster in terms of cost*” adding: “*Frankly, it’s very corrupt... no rational government, looking at the interests of the citizenry as a whole, would do this.*”⁶⁵

A growing body of evidence from the UK parliament’s Treasury Select Committee and Public Accounts Committee, and the UK government’s National Audit Office, confirms PPPs have failed to deliver value for money, have created outcomes heavily skewed in favour of private interests, and are built upon overly-optimistic models and assumptions that have borne little resemblance to reality.

Despite this highly negative overall experience of the domestic use of PPPs, the UK government is playing an active role in promoting PPPs to developing countries and presenting the UK’s own experience as a success story. For example, it set up and funds the Private Infrastructure Development Group (PIDG) which exists to promote PPPs to finance infrastructure in developing countries. Between 2002 and 2013 the UK’s Department for International Development has disbursed \$663 million from its aid budget to PIDG, covering two-thirds of the contributions by all donors.

The reason the UK government continues to promote PPPs around the world despite their disastrous record at home is because UK companies stand to benefit. After two decades of working on PPPs in the UK, British consultants, banks and legal firms, as well as various forms of PPP operators, see themselves as well placed to win contracts globally. Before listening to the advice of UK companies and the UK government, decision-makers across the world should take on board the disastrous record of PPPs in the UK.

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Front cover

4,000 people protest in Huddersfield in February 2016 against the closure of the hospital's Accident and Emergency Department.

Photo: Halifax Courier



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