Assessing Value for Money in PFI Projects: A Comparative Study of Practices in the UK and Italy

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Abstract

The Value for Money assessment is a critical process in procuring a Private Finance Initiative and it requires accurate ex-ante performance measurement methodologies. The British Government has set new requirements for evaluating VFM through a new assessment model composed of three main stages, namely: programme level assessment, project level assessment, and procurement level assessment. The objective of the new model for VFM assessment is to change the costly, inflexible and opaque side of PFIs in order to deliver cost-effective and improve the quality of public service provision.

A theoretical analysis of the implementation of PFI shows the UK as the leading user of this procurement in Europe and Italy is the second. However, there is a disparity in the manner PFI is actually implemented in these two countries and especially how VFM is assessed. Aiming at underlying the best practices of this evaluation process for the most achievable VFM, this paper presents the new VFM assessment model of the UK and a suggestion for its potential application to the Italian PFI procurement process to improve outcomes therein.

Introduction

The Private Finance Initiative (PFI) is a contemporary procurement model and the tendency is to use it to increase investments in social facilities and services, achieve Value for Money (VFM) and manage risk more efficiently. However, there is evidence that PFI is still used, at least in part, as a means of off-balance sheet financing. Moreover, PFI, when compared with other methods, is more capital intensive, involves an over-bureaucratic procurement process, lacks flexibility, and fails to correctly allocate risks to the parties involved (HM Treasury, 2011).

In this context, VFM becomes fundamental for the success of PFIs. Its main key drivers are associated with performance measurement and use of innovative output specification, optimal allocation of risk between participants and the right choice of rewards and incentives, emphasis on the whole life costs, flexibility and transparency, adequate skills and expertise, detailed and careful definition of the terms of the contract, and, finally, accurate project management aimed at the best combination of quality, cost effectiveness and timely delivery of the project.

To address all of these issues, the UK Government has set new requirements for evaluating VFM through a new assessment model. The objective of the new model for VFM assessment is to change the costly, inflexible and opaque side of PFIs in order to deliver cost effective and VFM public services. The new approach is less expensive, should involve more financial sources and better balance the risks and rewards to the private sector. At the same time, it should be flexible in fulfilling the public sector's needs and efficient in delivering the project in term of quality, cost and time, through a cheaper and quicker procurement process and financial transparency. It is expected that the model will be tailored appropriately to reflect the requirements of any type of project.

Aiming at underlying the best practices of this evaluation process for the most achievable VFM, this paper presents the new VFM assessment model in British PFIs and proposes its potential application to PFIs in Italy.

In particular, the study is structured as follows. First, a framework of Public-Private Partnership (PPP) and PFI is provided through an analysis of the existing literature. Second, the VFM topic is presented together with the new VFM assessment methodology developed by the British government in 2006. Then, the weaknesses of PFI in Italy are analyzed. Finally, the application of the new British VFM assessment methodology is proposed for potential improvement of the Italian PFI procurement process.

Project Finance and Value for Money

A Public-Private Partnership (PPP) is a contractual agreement between a public authority and a private entity that provides a public service or project and assumes financial, technical and operational risks. PPP encourages a more efficient risk sharing and it allows leveraging on private finance to face public finance shortage.

The PFI is a particular form of PPP. Under the terms of a PFI, a Special Purpose Vehicle (SPV) is financed with equity and either non-recourse or limited recourse debt. The first PFI was launched in the

UK in 1992 as a way to finance infrastructures in an efficient and effective way with good quality work completed within time and budget. Moreover, PFI is preferred in light of a better VFM compared with the public initiative and public authorities push to adopt it. In particular, it can bring to more efficient risk allocation in the sense that risks are borne by the party best able to manage and control them (Merna and Smith, 1999). The public granting authority presets the desired performance of service without listing any input, and since the project is awarded through a tendering process, VFM becomes a crucial aspect for proposers to win the bid (Pitt et al. 2006).

According to HM Treasury (2007), VFM is the optimum combination of lifecycle costs and quality of good or service to meet the users' requirement. Traditionally, VFM has been considered as a combination of three different aspects of the service delivery, namely: economy, efficiency and effectiveness. Economy is related to the lowest payment for a certain service. Efficiency is the ratio between the delivered services and the resources that are consumed. Effectiveness translates in the degree to which the service is fit for purpose (Brown, 2007).

VFM can be calculated in terms of Net Present Value (NPV), namely the cost of the project for each year of the contract discounted to what the project would be worth at today's price. Broadbent et al. (2003) point out the importance of both financial and non-financial aspects, suggesting the analysis of a wide set of variables to determine VFM.

PFI in the UK

PFI was first introduced in the UK in 1992. Since then, more than 700 PFI contracts are delivering a wide arrange of public assets for establishments of the English government. PFI was born in response to the privatization of many public services (Pollock and Leys, 2005) and nowadays it is the main procurement model in the healthcare sector and the tendency is to use it to achieve larger investments in social facilities and services, together with a better VFM and risk management. It is considered crucial for improving the quality and the cost-effectiveness of public services (Holmes et al., 2006).

The UK has formalized PFI in its legislation and has made public bodies an active part in the whole PPP mechanism. UK government standardized the contractual system aiming at providing guidance on the key issues that arise in PFI projects, promoting the achievement of balanced contracts and enabling the public sector procurers to meet their requirements. The UK has been able to create a market for British companies and PFI expertise. In this way it can be possible to deliver the best VFM.

The English Treasury Committee has examined among the expenditures of HM treasury the PFI topic through a VFM perspective. The idea was to improve the PFI procurement process in order to ensure a more effective use of the private sector innovation and skills and reduce all the costs related to the project without affecting the quality as well as improving flexibility and transparency. In the UK two-third of the total investments being carried out between 2011 and 2015 will be privately funded while the remainder will either be partially or fully public financed (House of Commons, 2011). This fosters the need of a new approach to coordinate public and private investment for enhancing the success of the outcomes.

The UK Government has worked on providing a guidance for a clear VFM assessment. In particular, the methodology should audit all the assumptions to test if they are reasonable. The analysis couches on both quantitative and qualitative appraisals. Quantitative analysis should be supported by a sensitive analysis so that to consider qualitative elements associated with viability, achievability and deliverability of the proposed solution. Furthermore, the analysis should take care of the correct establishment of public finances in the sense that the funding system should not increase the overall burden on taxpayers. Another important aspect is related to openness and transparency: the availability of more information about returns to investors in PFI projects would be helpful to inform public sector judgements about VFM. The achievement of VFM is based on a fair competition that enables providers to deliver high quality services and improved efficiency.

The VFM process involves both the procurement process, the preconstruction phase, and the whole life of the project (Merna and Njiru, 2002). The National Audit Office (NAO) (2012) identifies ten different key aspects related to VFM. These include: setting rules for ensuring competitive market to protect consumer's interest and ensure that businesses are fair and competitive; enabling users to participate actively in the market through the access to information in order to get to the most effective choice; promoting fair competition between providers in order to allow to everyone to take part to the bidding process; ensuring the market is delivering the public policy objectives so that to understand if VFM is actually achieved.

The HM Treasury (2006) established a VFM assessment guidance for PFI projects. This is based on the following three different stages of the process:

Stage 1: Programme level assessment. It provides a clear strategic direction whilst indicating where there may be a need for flexibility in the chosen procurement route for some projects.

Stage2: Project level assessment. It is designed for project teams to test that the indicative VFM conclusions from Stage 1 is relevant for the specific characteristics of the individual project taken into account.

Stage 3: Procurement level assessment. It demonstrates that a competitive bid-process has been conducted for the selected PFI bidder, ensuring that all the parties involved are fully appraised of market conditions and can identify early problems through on-going checks on VFM.

Each stage entails a combination of both qualitative and quantitative assessments. Since August 2004, with the last updates done in November 2006 and March 2007, the HM Treasury has been factually working on new requirements as well as on new PFI routes towards achieving the best VFM. This new approach considers the guideline steps from the Outline Business Case (OBC) to the Full Business Case (FBC), a parallel usage of a qualitative and a quantitative assessments and the use of the HM Treasury standardized templates. The new form is mandatory for all projects after its last publication in November 2008. The new assessment includes three annexes and a spreadsheet report for the financial evaluation of the final value. Application of this new model for assessing VFM results in a report including: a qualitative analysis of viability, desirability and achievability; a quantitative spreadsheet model that includes the sources and the justification for the chosen input values and a summary of the results with sensitivity analysis.

Running in a proper way the new model allows supporting the procurement process of the public sector through implementation of best practice in the project, program, service and risk management, with the resultant best achievable VFM.

VFM assessment is mandatory with initiatives that are greater than £20million, which is also the minimum suggested threshold for using PFI. The first part of the OBC has to include an identification of the objectives of the investment with the associated expected benefits, a generation of a list of options for meeting the objectives of the investment, an assessment of the costs and benefits of the listed options, a risks analysis, and an identification of the options.

The OBC is then presented to the NHS Executive Regional Office for discussion and brainstorming. At this point the FBC is carried out in order to validate the previous OBC work and to develop the preferred option. It consists of four different stages, namely: review, professional certification of the director of the NHS body, detailed development of the selected option, and formulation of plans for

project monitoring and post project evaluation. An accurate assessment of VFM is able to grant the best trade-off involving the quality of a service at a fair cost in the best efficient and effective possible way.

PFI in Italy

The first PFI project in Italy dates from 1999. In terms of level of usage, the Italian PFI market is second in the list after the British one among all European countries. Nevertheless, the Italian approach to PFI and to VFM assessment is rather different.

Basically, PFI was introduced in Italy because of the urgent need of the public sector to find a sustainable way to construct or renovate infrastructure, in light of the obsolescence of existing ones, the need to adapt the existing structures to new technologies, and the lower use/cost of available public resources (Barretta and Ruggero, 2008).

De Marco et al. (2012) confirm the necessity to recur to PFI to build new hospitals or to upgrade existing facilities, since traditional public finance is not sufficient to satisfy the national demand of infrastructures. At the same time Gatti and Germani (2003) underline that in Italy the private sector has often difficulties to retrieve the initial investment and to overcome this issue public contribution can be increased or more ancillary services can be provided.

In addition, Italy lacks an institutional body that supports and stimulates PFI. General guidelines for ex-ante, in progress and ex-post evaluation are not available, and a structured methodology for the assessment of VFM does not exist so far. Also, the Italian market is not mature enough to welcome this kind of approach even if governments have tried to introduce some reforms in legislation. What is still missing is the availability of tools such as standard contract guidelines and reliable measures for cost effectiveness appraisal.

Moreover, there are no incentives for greater competition and structured bodies to evaluate and sustain PFI projects. This is due to the fact that public administrations have not recognized the importance of a rigorous measurement system and of an efficient allocation of risk among the involved parties.

Italy is experiencing a slowdown in the growth of PPP projects because the current global financial crisis has led the private sector into borrowing difficulties and weakening of the private sector's propensity for risk, as part of the general trend of the Italian PFI market, as shown in Figure 1 (Finlombarda, 2009).

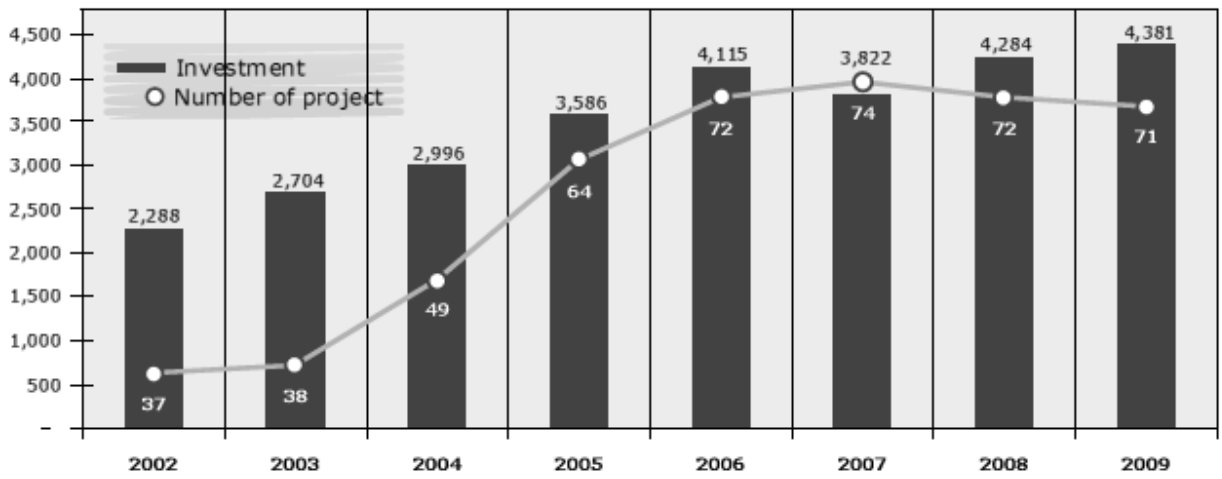

Figure 1. Trend in PFI Investments in Italy

Other critical issues are related to the long duration of procurement procedures, the difficulty in evaluating the proposers' documentation, the troubled coordination among participants, and, in turn, the financial plan for the project. All these criticalities have made PFI more expensive compared with the traditional contracting mechanism. The odd fact is that Italy just imported the general ideas of PFI from the UK without taking inspiration to solve all the problems associated with its implementation. That is why recently there is the tendency to turn to alternative forms of procurement such as leasing, joint ventures and strategic PPP partnerships. PFI has proved to have a lot of potential, but it requires further development of appropriate methods and tools for VFM assessment to ensure it delivers successful outcomes and performance.

Critical Analysis

In the last two decades, PFI has become one of the most used procurement methods because of its promise to leverage on private finance in order to develop new infrastructure without additional burden on public budgets. On the one hand, it allows reducing the backlog in the delivery of public services and a delivery system to achieve good VFM. Evidences show that the PFI mechanism is able to generate better VFM than traditional procurement methods if conducted properly. All the aspects related to service delivery, risk, quality, and time need to be evaluated through a comparison of different schemes, in order to figure out if PFI actually offers the best VFM.

Over the last two decades, the British government has come to foster the advantages and to seek to reduce the disadvantages of PFI. In this regard, it has been realizing that PFI can enable the public

sector to access the discipline, skills and expertise of the private party. On the other hand, it has tried to find solutions to enhance it via a more rigorous definition and application of a proper VFM assessment methodology.

On the contrary, although Italy commands the second largest volume of the PPP market in the European Union, its implementation is still lacking structured guidelines to assess VFM. In turn this has contributed to significantly jeopardize the PFI efficiency and effectiveness. Italy should take the UK as a benchmark. The introduction of the British VFM assessment model could radically improve the PFI mechanism.

Conclusions

A theoretical comparison between Italy and the UK has been carried out with the purpose of understanding the VFM assessment models and their application to the healthcare sector in particular. The study points out that the assessment procedure needs to be fair simple and clear. The governments and their local bodies should work together in order to favour the right investment decision, get the best efficiency and efficacy from the available resources and achieve, desirable services.

The British public institutions have developed a standardized methodology for the evaluation of VFM of PFIs and this has brought to an efficient expenditure of public resources, a better risk allocation and an improved quality of provided services. On the contrary the Italian market is still facing many problems regarding PFIs such as high litigation, major cost overruns and service inefficiencies. A structured model based on the British experience might help Italy to fully exploit all the benefits related to the PFI mechanism. For this reason future research is currently addressing the development of a template that can support both public and private professionals in managing all the uncertainties of PFI, and in turn extrapolating the maximum achievable VFM.

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