Public Sector Procurement of Capital Works

A Comparison between “Conventional” and PFI Methods

Many politicians become involved with the public sector procurement process in their careers, but the amount of training that they receive is often very inadequate, leaving them totally reliant on their officers’ advice. Many officers, perhaps unfortunately, are happy to keep it this way as they feel it makes their lives easier than might be the case if the members understood what they are doing. This brief paper is intended to outline some of the main approaches, and to look at some of the issues that these approaches can give rise to.

What are Capital Works?

Most public authority spending falls into one of two main categories. Most spending is what is termed “Revenue” spending – this is things such as staff salaries, travelling costs and the day-to-day cost of providing accommodation. In comparison, there are major items of investment such as roads, school buildings, hospitals and ports which are known as “Capital” works. These are normally things that will have a long working life in the service of the community, and this paper looks particularly at how we pay for these. Most authorities and departments have relatively few such projects at any time.

“Conventional” Procurement

Capital works tend to be very costly, and it is helpful to the purchasing department or local authority to spread the cost over a period of years. In the conventional process, the spending body borrows the money to pay for the works from the Treasury, normally over a period of 60 years. Interest is charged on this loan at a rate slightly above Treasury Bond rate (i.e. the rate the Government has to pay on the money that it borrows). Effectively, the purchasing body takes a long term, low interest rate mortgage from the Treasury. The Treasury itself usually pays a very low interest rate on its debt, because there is generally perceived to be a very low risk of the Government failing to repay its debt.

Obtaining permission to undertake expenditure that needs to be financed by a Treasury loan is referred to as gaining “Loan Sanction” for the project. The Treasury sets out the procedure that Departments must follow in order to obtain Loan Sanction for any proposed works in what is known as the Treasury “Green Book”. These procedures are overseen by the Public Accounts Committee.

The repayments on these loans are seen as revenue expenditure.

The Treasury, alone among Government departments, does not make this distinction between “Revenue” and “Capital” expenditure. All government expenditure is accounted in the year in which it is made. Some projects will incur costs spread over several years, and then the cost in each year is accounted for in that year. The logic of this is that – broadly – given the number of Departments and local authorities borrowing from the Treasury, and hence the

large number of projects being processed, it levels out year-on-year. The Treasury, therefore, does not take a mortgage for any project that it finances.

This method of procurement is traditionally open to a good level of democratic scrutiny both by the commissioning body and by Parliament.

What Difference Does the EU Make?

It is important to understand the key effects of our EU membership. The EU rules are designed to enable any suitably qualified firm, anywhere in the EU, to compete on as nominally a level playing field as possible for any but the most minor public sector supply contracts. In essence, they strive to ensure fairness between competing suppliers.

Much of this has been achieved by reducing the impact of individual country's historical design standards, which were often used to create a fence around works in that country. Thus German DIN standards where subtly different from nominally equivalent British Standards thus often excluding British firms from competing for German contracts. The EU has mandated that if a product is suitable for purpose X in Country Y, it also suitable for that purpose in country Z.

This change has obviously had an increasingly profound effect on how specifications for products and works are structured and written.

As well as developing this parity of technical standards the EU requires that all intended contracts should be advertised across the whole of the EU, normally by a notice published in the "Official Journal of the European Union" (OJEU). A set of tender documents is then issued to any organisation who may wish to tender for the work, and this documentation must set out both what is to be supplied and how the different tenders are to be assessed against each other.

If the proposed basis of assessment is biased in favour of one supplier, the process can be challenged and ruled illegal, with a significant fine levied on the procuring body and a substantial delay to the contract. Thus it is not acceptable to state that "French widget manufacturers will be given preference" but it is acceptable to look at the socio-economic consequences of each tender, if these are stated openly in the original documents. We can therefore – entirely legally - say that the submitted bids must include an analysis of the impact of this bid on the widget-making industry of Normandy or wherever. This may, of course, invite a bidder to propose opening a brand-new widget-making factory in the area concerned, and it may well be that that offers little protection to the indigenous widget makers.

PFI Procurement

Because the Treasury accounts the entire cost of capital works in the year in which the expenditure is made, if the Government of the day wishes to invest in many projects at the same time as each other the bills can mount up quite significantly. In order to attempt to address this issue, John Major's administration came up with the idea of effectively buying public works on commercial mortgages – whence the term "Private Finance Initiative".

At its heart, this is a scheme, designed by the banking community, to persuade governments to borrow money from them for capital projects at much higher interest rates than would be the case for conventional government borrowing. The banks persuaded the politicians to look at the issues of each scheme on its own, rather than looking at the overview of how governments operate. In this view, buying infrastructure on the "never never" looks – initially - attractive. Like so many things in today's rip-off Britain, it turns out to be a very bad deal indeed when you actually add up how much it will cost you over the life of the scheme.

In this system, the government has the works built for them with the capital cost borne by a loan taken out by the builders of the works. This is then repaid by the government over a period of thirty years. In the case of a road, the repayments may be linked to the amount of traffic using the road, but in the case of a school or hospital an agreed level of repayment is established in the contract.

The original intention of government was that this process would be led by the builders or makers of the products being purchased, but because the cost of this process is so sensitive to the financial deals that can be arranged in many cases the successful tenderer is a consortium led by a bank or finance house. These organisations have little understanding of - or commitment to - the measures needed to create a product of proper robustness and quality.

It must be observed that these loans will be charged at a significantly higher interest rate than that attaching to Treasury Bonds, and this, coupled with the loan being repaid over thirty years, makes the annual cost of the project to the purchasing department or authority significantly higher than would be the case for conventional procurement. For instance the extra cost of the PFI-funded hospital building is a major factor in the current financial difficulties of the NHS. The same impacts are being felt in our schools, universities and even emergency services.

At the same time as introducing this method of procurement, the government decided that it would be a good idea to focus builders' attention on the long-term performance of the buildings or works that they were creating. To do that, they require the Building / funding team to be responsible for the maintenance of the works for the entire thirty years life of the contract. In practice, the original builders tend to divest themselves of this responsibility as quickly as possible, either by letting another company take on this part of the work for a share of the annual revenue, or by selling the contract to them. Because the works are in place, on the ground, the purchasing company can raise its loan to buy the works at a much better interest rate than that which the builder had to pay. These savings are rarely, if ever, passed on to the commissioning department or authority.

There is a significant temptation to purchasers to roll up a whole array of issues into one contract – for instance the construction of vehicle maintenance depots and the routine maintenance of vehicles may be bundled in with a contract to supply those vehicles. This creates a danger that the contract will be assessed on the basis of the organisation that creates the best financial bundle, rather than making the best products.

The current contract to build and supply the rolling stock (trains) for the upgraded Thameslink scheme is a prime example of such a contract, where the scheme includes all the rolling stock maintenance for a thirty year period and the construction and operation of the train maintenance depots for the line. The cost of the rolling stock may well be less than half the overall cost of the project. It is clear that this approach favours suppliers who are used to this sort of integrated approach, rather than British suppliers who have historically built the

stock and passed the operation on to other organisations. British managements have traditionally taken the view that it is better to have specialists in each activity doing what they are best at, rather than trying to be "jacks of all trades".

It should be noted that having the maintenance (and often cleaning) included in the PFI contract leaves the purchasing authority with no option to make savings in the future by adjusting the amount of cleaning work done or by investing in more advanced equipment to make day-to-day savings. The cleaning and maintenance staffs are usually employed on much poorer rates and conditions of service than their equivalents in local authority direct works teams. Because of this, the workers feel less included in the team, and staff morale and working standards all too easily decline.

These schemes are generally negotiated on a "commercial and in confidence" basis, which precludes any effective scrutiny, even by Members of a purchasing authority.

In Conclusion

From the discussion above, it is clear that the PFI approach to procurement is a "smoke and mirrors" exercise that only benefits the bankers and can introduce some unfortunate issues into the assessment of the competing bids. The European Union rules seek only to give all suitable competent European firms a fair competitive pitch across the entire EU, and so they probably benefit British firms more than they hinder them.

It is clear that the increased cost of servicing these PFI contracts - in comparison to the costs of conventional procurement - amounts to a significant cut in the budget for front-line services across many aspects of the public sector, and in some cases this is having a greater impact on the money available for front line services than the direct cuts being made by the government.

The party should strive (and indeed our HQ policy teams are developing policy with this aim nationally) to move the public procurement back to its more traditional model, both to save cost, in particular by effectively reducing the total cost to the Treasury of public sector borrowing (including borrowing on behalf of the public sector) and to increase proper democratic scrutiny of the procurement process.

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