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CS-227 Project Preparation and Risk Allocation Under a PFI Deal

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Background of PFI

For Many years it was taken for granted that public infrastructure be constructed, operated and maintained by the public sector using its own funds. This has, however, been questioned globally in recent years mainly due to the shortage of public funds and an increasing public awareness of value for money. One alternative solution is to develop capital infrastructure projects with private funds and managerial skills through Private Finance Initiative (PFI) schemes. The most typical procurement arrangements for PFI schemes take the form where the private sector, under a contract with the public sector, builds infrastructure with its own money and then operates and maintains the built assets on a commercial basis to recoup the investment. The assets will then be transferred back to the public sector upon the expiry of the contract period or when certain conditions, such as total revenue, stipulated under the contract are met.

Since the PFI method immediately reduces financial burdens on the public sector, there are not a few cases where the public sector hastily resorted to PFI schemes without giving due considerations and ended up in failure. This paper discusses the critical issues at project development and procurement stages which are decisive factors to the success of PFI.

Requirements for a Successful PFI Project

Although factors for the success of a PFI project varies widely with projects, the following are decisive factors common to most projects:

- Project selection
- Project preparation
- Appropriate allocation of risks between the public and private sectors
- Fair and competitive bidding

Project Selection

The failure of a PFI project is not only a loss to the private sector, but also brings about a great deal of adverse impact to the society and economy. As such, project assessment in relation to the suitability of PFI is strongly advocated. To this end, the public sector should thoroughly appraise candidate PFI projects as to their various aspects, including needs, financial viability, public opinions, and procurement options between conventional and PFI methods from the viewpoint of value for money.

Furthermore, the project should be in line with strategic government policies to avoid a disorderly development of infrastructure. The public sector is responsible for providing infrastructure which may not necessarily be financially viable but essential to meet social needs. Hence, it is desirable for the public sector to identify medium and/or long-term infrastructure development projects with an indication of procurement type for each of them, public works or PFI, based on a preliminary assessment and evaluation thereof.

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Project Preparation

PFI is all about creating a structure that improves value for money through private innovation and managerial skills. Therefore, the project should be defined and its specification set out in such a manner that minimizes the client's requirements, allowing ample room for the private sector to make the best use of it's own resources and expertise. This is achieved through drafting an output specification giving the private sector freedom on how to build, operate and maintain the project. A comprehensive and accurate output specification is an essential part of the procurement process. It is important to state clearly and accurately the project's core requirements. The core requirements make up a definition of the essentials of what the public sector is seeking to procure. An output specification should:

- state the requirements clearly, concisely, logically and unambiguously;
- state what is wanted, not how it is to be provided;
- allow bidders to propose innovative solutions;

Appropriate Allocation of Risks

The life of a PFI project contract generally ranges as long as 20 to 30 years and there will always be a wide variety of risks associated with the project.

The main benefit of risk transfer is that it generates the incentives for the private sector to supply cost effective and higher quality services on time. Risk and reward go hand in hand. The optimum allocation of risk, rather than maximizing risk transfer, is vital to ensure improved value for money. The principles governing risk transfer is that the risk should be allocated from the public or private sector to whoever is able to manage it at the least cost. However, it does not mean all risk is transferred simply for its own sake.

The appropriate risk allocation is specific to a particular project and varies between projects. Below is a table illustrating the allocation of key risks in a PFI toll road project.

Typical Allocation of Risks in a PFI Toll Road Project

Type of Risk	Public Sector	Private Sector
Planning	Statutory Procedures	
Designing		Mainly
Land Acquisition	Mainly	
Financing		All Risks
Construction Cost/Time		All Risks
Traffic Volume	Shared	Shared
Protestor Action	Major Ones	Minor Ones
Force Majeure	Major Ones	Minor Ones
Legislative Change	Discriminatory	Non-discriminatory

Fair Competitive Bidding

To achieve value for money, the selection of the PFI company through competitive bidding is a prerequisite. There are three competitive procurement routes; open, restricted and negotiated procedures. The negotiated procedure is suitable for the project which gives the private sector freedom on how to implement the project with an output specification as being the case with PFI projects. In the negotiated procedure, the preferred bidder selected in a competitive process negotiates the contract terms and offers the best and final bid. A negotiated method should meet the principles of transparency, objectivity, and non-discrimination.