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Building and managing facilities for public services ☆

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Abstract

We model alternative institutional arrangements for building and managing facilities for provision of public services, including the use of the Private Finance Initiative (PFI), by exploring the effects on innovative investment activity by providers. The desirability of bundling the building and management operations is analyzed, and it is considered whether it is optimal to allocate ownership to the public or the private sector. We also examine how the case for PFI is affected by the (voluntary or automatic) transfer of ownership from the private to the public sector when the contract expires. Asset specificity and service-demand risk play critical roles.

JEL classification: D23; H11; L33
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1. Introduction

The provision of public services is often organized through contracting out by governments to private profit-maximizing firms. Recently, however, governments in Western Europe and North

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America have developed new forms of public–private partnership (PPP) for public service provision (Rosenau, 2000). A form of PPP that has attracted particular attention is the Private Finance Initiative (PFI) developed in the UK (Grout, 1997; HM Treasury, 2000). PFI contracts cover most forms of public service provision, including health, education, defence, prisons and roads. HM Treasury (2003) estimates that, over the period 1998–9 to 2003–4, private sector investment in public services through PFI was between 10 and 13.5% of total investment in public infrastructure, with 451 PFI projects completing construction, including 34 hospitals and 119 other health schemes, and 239 new and refurbished schools.

There are two major differences between PFI and previous arrangements. First, PFI typically involves the bundling of the design, building, finance, and operation of the project, which are contracted out to a consortium of private firms for a long period of time, usually 25–30 years. The consortium includes a construction company and a facility management company and is responsible for all aspects of services. Second, a system of output specifications is used: the government specifies the service it wants, and some basic standards, but it leaves the consortium with control rights over how to deliver the service. The consortium has responsibility for the infrastructure facility during the contract period, during which it may implement innovative approaches to service delivery and it may use the facility for additional income-generating activities — provided the basic standards of service provision are not violated. However, there is no specific rule as to what happens to facilities at the end of the contract, although, in practice, in the few contracts that have been completed, in the cases of schools, hospitals and prisons, the facilities have been returned to the public sector, whilst for accommodation and general IT systems, they have been kept by the private sector (HM Treasury, 2002, 2004).

PFI contrasts sharply with the way public services have traditionally been procured. Under traditional procurement (TP) the different stages of an infrastructure project are contracted out separately to different private firms and an input-specification approach is followed, with the government keeping ownership of the facility both throughout the contract period and after the contract ends (HM Treasury, 1998).

The primary motivations for PFI schemes are to allow the consortium to exploit synergies between different stages of a project, and to incentivize the consortium to come up with innovative approaches to service delivery (Daniels and Trebilcock, 2000; IPPR, 2001).[1] Yet, evidence on the performance of PFI, relative to that under TP, is mixed. On the one hand, a greater proportion of projects is being delivered on time and within budget than under TP (National Audit Office, 2003b). In PFI prisons, for example, innovative solutions have been incorporated that had not featured previously, and there is evidence that greater benefits and lower costs are being achieved (National Audit Office, 1997, 2003b). On the other hand, the quality and cost of some early PFI schools have been worse than under TP (Audit Commission, 2003).

In this paper we analyze the factors underlying these stylized facts.[2] First, we study the desirability of the two defining characteristics of the PFI model: whether it is optimal to bundle the different stages of production and whether control rights should be given to the private firm(s). Second, we focus on an important practical concern for public infrastructure projects involving long-term private investments: the role of the residual value the facility, and of ownership of the

[1] Specifically, HM Treasury (2003) states that '[t]he public sector defines the service to be delivered, but it is for the private sector partner to decide how to deliver it, drawing on its own *innovation* and experience. This provides the private sector with an incentive to develop innovative ways to meet requirements, and allows the public sector to harness the efficiency that can come from contestability, helping improve standards across the public sector.' (Emphasis in original).

[2] This is a much revised version of Bennett and Iossa (2002).