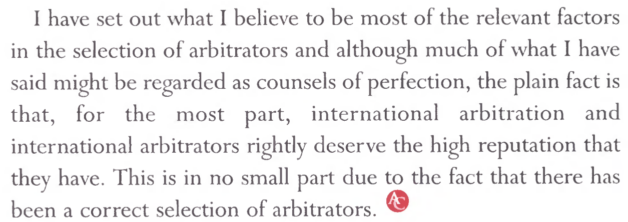
arbitrators, but specialist arbitration institutions such as the ICC, the London Court of International Arbitration, the AAA or other institutions have considerable knowledge of suitable people to act as arbitrators, especially as they often make appointments.

(11) There are benefits to having a three-person tribunal although there are undoubtedly certain disadvantages.

(12) In international matters, not only must an arbitrator be competent in his or her own jurisdiction but he or she should have an understanding of other systems of jurisprudence or of other legal systems.



I have set out what I believe to be most of the relevant factors in the selection of arbitrators and although much of what I have said might be regarded as counsels of perfection, the plain fact is that, for the most part, international arbitration and international arbitrators rightly deserve the high reputation that they have. This is in no small part due to the fact that there has been a correct selection of arbitrators.

David Winter OBE

Baker & McKenzie

Myths surrounding the PFI in the UK

by Christopher Bovis

Christopher Bovis

In this article the author endeavours to demonstrate the theoretical and practical background of some of the most important issues surrounding the PFI as part of the government's attempt to institutionalise governance by contract.

The PFI represents a process of public sector management which envisages the utilisation of private finances in the dispersement of public services and the provision of public infrastructure. The principal benefit from such an exercise could be that the public sector does not have to commit its own, often scarce, capital resources in delivering public services. Other reasons put forward for involving private finances in delivering public services include:

- quality improvement,
- innovation,
- management efficiency and effectiveness,

elements that are often underlying private sector entrepreneurship. Consequently, the public sector would receive value for money in the delivery of services to the public, whereas it could also be maintained that, through this process, the state manages public finances in a better way, to the extent that capital resources could be utilised in priority areas.

ROLE OF THE PFI

The PFI has arrived in times when the role and the responsibilities of the state are being redefined. Also, alongside the privatisation and contracting out processes, it has been seen as part of the exercise in slimming the state down to a bare minimum of fiscal responsibilities towards the public. The PFI has resulted in changing the traditional nature of the state with regard to asset ownership and the delivery of services to the public. The state, under the PFI, assumes a regulatory role, whereas the private sector is elevated to asset owner and service deliverer.

There are two broad categories under which privately-financed projects can be classified.

Financially free-standing projects

The first covers the so-called *financially free-standing projects*, where it is expected that the private sector designs, builds, finances and then operates an asset. The recovery of its costs is guaranteed by direct charges on the users of the service which the particular asset provides. These projects are often described as *concession contracts*, where the successful contractor is granted an exclusive right over a period of time to exploit the asset that it has financed, designed and built. The state and its authorities may also contribute, in financial terms, to the repayments in order to render the project viable or the service charge to the end users acceptable.

Provision of services by the private sector

The second category of privately-financed projects embraces those which have as their object the provision of services by the private sector to the public, in conjunction with and subject to the relevant investment in assets that are necessary to deliver the required service to the public. In such cases, the private sector provider is reimbursed by a series of future payments by the

contracting authority, payments which depend upon the successful delivery of those services in accordance with certain specified quality standards.

EMERGENCE OF THE PFI

When the PFI was launched in 1992 by the Conservative administration, it did not receive the envisaged response from either the public or the private sectors. The initial approach to privately-financed projects by the public sector represented a disguised tendering for their financing and, as such, it revealed a number of procedural and commercial inadequacies in the whole process. Policy makers incorrectly assumed that the mere private financing of projects could enhance their quality and value for money, as well as transform the often ill-fated traditional public procurement process into a supply chain system of advanced structure and entrepreneurial flair. The PFI was wrongfully conceived as a panacea for the limitations of the traditional public procurement process, which was blamed for inefficiencies and poor value for money. A number of reasons which have been put forward include, inter alia, poor specification design, wrong contractual risk allocation, poor control systems for contractual performance and bad planning and delivery processes.

In principle, privately-financed projects destined for the public sector have been an option in the UK public procurement process since the eighties, where the government, with a great deal of caution, allowed the conclusion of a limited number of contracts. The government applied the so-called *Ryrie Rules* in the process of allowing private finances to be used in public projects, subject to two strict conditions. The first concerned the cost-effective nature of the privately-financed delivery in comparison with a publicly-funded alternative. To reach such a conclusion, contracting authorities should have established a *public sector comparator*, whereby the privately-financed delivery model could be tested and compared against the traditional publicly-funded one. The second condition for the government to give clearance for a privately-financed project related to the compulsory substitution of publicly-funded schemes with the privately-funded ones. In other words, private finances were conceived as an exclusive alternative method in delivering public services, not as a complementary one.

Meeting the Ryrie conditions

Meeting the two conditions of the *Ryrie Rules* was not an easy exercise for public authorities, particularly in attempting to establish the cost-effective nature of a privately-financed project versus a publicly-funded alternative and its value for money. Quite often the rationale behind such comparisons was founded upon unsound grounds. For example, in order to achieve a meaningful comparison, the two delivery models should be benchmarked against a set of *variable parameters* (e.g. technical merit, quality of deliverables, aesthetic reasons, maintenance facilities, warranties and, last but not least, overall price). This was not always the case, as the specifications of the project were firmly predetermined from the outset by the public authority in question and the pricing of a project evolved around them. Hence the only variable parameter to compare the two delivery models unfolded around pricing. The procurement of privately-financed projects was a disguised tendering for their financing, and as such was bound to have very limited impact upon the procurement process. There was little chance that the private sector could beat the privileged position governments enjoy in the financial markets and raise the capital required to finance a service or an infrastructure project in more preferable terms. Furthermore, the private sector would normally require extra levels of capital return for the deferred payment facility that the public sector would use for repayments during the life of the contract. In the light of the above considerations, it is not a surprise that only a handful of privately-financed projects were concluded, particularly complex projects of massive scale and of multi-national dimension.

Against this background and bearing in mind the recently imposed restraints on public expenditure, e.g. prudence in Public Sector Borrowing Requirement (PSBR), EMU convergence criteria, the PFI was given a new lease of life when the 1997 Labour Government committed itself, in principle, to the concept and as a consequence, public authorities in the UK have been required to explore all potential ways of involving private finances in their public procurement process prior to committing their own funds.

INTELLECTUAL ORIGINS OF THE PFI

The origins of the PFI could be traced in the attempts to moderate the widespread dissatisfaction from traditional public procurement methods. The nexus of contractual relations between public authorities and the private sector has been often criticised for not giving the best value for money. The criticism has been primarily directed towards three elements of the process:

(1) adversarial contractual relations as a result of compulsory competitive tendering;

(2) inefficient risk allocation; and

(3) poor contractual performances resulting in delayed and over-budgeted completions.

PFI versus competitive tendering

Competitive tendering in public procurement has been reproached for creating a confrontational environment, where the antagonising relations which emanate from the tendering and contract award processes are often reflected in the performance stage of the contract. Public procurement procedures which are based upon a win-to-win process have been deemed to deprive significant elements one can expect in the delivery of public services. For example, competitive tendering has been dissociated from innovation and quality. Also, as a result of inefficiently written specifications upon which the tender should be constructed, the deliverables often differ dramatically from contractual expectations.

On the other hand, risk allocation is probably the most crucial element in contractual relations that affects pricing as well as the overall contractual framework. Risk represents the level of financial exposure of a party prior to, after the conclusion of a contract or during its performance. In traditional public procurement, the risk allocation tends to favour the supply side, which mainly assumes the risks related to the tendering process. During the performance stage of the contract and up to its completion, the demand side could usually shift a considerable amount of risk, by requesting from the supply side performance or defects bonds, or other means of financial guarantees.

Finally, traditional procurement methods have often revealed a picture of poor contracts management as a result of inefficient control systems operated by public authorities. Poor contracts management has resulted in abysmally out-of-control contractual performances with all the financial consequences attributed to the delayed completions of the projects.

Competitive tendering, amongst other things, has been deemed responsible for cyclical demand structures in public purchasing, a situation where the supply side (the industry) responds to the demand side (public authorities) through cycles of institutionalised bureaucracy (tender submission, selection, evaluation and contract award processes). The demand side has institutionalised the procurement process by imposing a disciplinarian compartmentalisation of the relevant processes (advertisement, expression of interest, selection, qualification, tender, contract award).

The institutionalisation of the procurement process intends to facilitate the main objectives of the European public procurement rules:

- the establishment of the principles of transparency and competitiveness in the award of public contracts; and
- the achievement of savings for the public sector.

The bureaucratic system which supports traditional public procurement uses the effects of transparency as leverage for value for money results. The fact that more suppliers are aware of a forthcoming public contract and the fact that interested suppliers are aware that their rivals are informed about it, indicates two distinctive parameters which are relevant to savings and value for money:

- focus on value for money for the demand side and the possibility for contracting authorities to compare prices and quality;
- effect on the suppliers who, inter alia, can no longer rely on lack of price comparisons when serving the public sector.

Openness in public procurement, by definition, results in price competition and the benefits for contracting authorities appear achievable. The institutionalised nature of the public side of the procurement process also reflects the relative balance of powers in the demand/supply equation. However, the traditional public procurement process often suffers from unnecessarily repetitive functions (in particular the advertisement, selection and qualification processes) which can be cost ineffective and pose a considerable financial burden on the demand side.

Against this background, the PFI was originally construed as the process that could bring the public and private sectors closer and break the mistrust which has surrounded traditional public procurement. The PFI should not be conceived as a capital facility to the state and its organs in the process of delivering public services. It should not been seen as a borrowing exercise by the public sector, as the latter can acquire capital in much more preferential terms than any private person. The PFI should rather be conceived as a process of involving the private sector in the delivery of public services. As such, the PFI attempts to introduce a contractual element in the delivery of public services, to the extent that the private sector, as a contractual party, undertakes the responsibility to provide not only an asset but to deliver its associated functions to the public. Therefore, the PFI has contributed to changing the traditionally acquisitorial nature of public sector contracts by inserting a service delivery element.

PFI versus PSBR

One of the most important attractions of the PFI has been the ability of public authorities to classify the relevant transactions as exempted from the PSBR, thus by-passing centrally controlled budgetary allocations and cash limits in the public sector spending. In such a way, the PFI represented a viable solution to cash-stranded public authorities which could, independently, proceed and strike deals that otherwise would not have materialised. Furthermore, the public spending relating to the repayments of the privately-financed transactions would not appear as public debt. By taking privately-financed transactions out of the PSBR balance sheet, the government may implicitly have attempted to liberalise public purchasing from budgetary constraints and public spending capping. It could be also argued that such an attempt could indicate the beginning of the end to the institutionalised decision-making process and control of public procurement imposed under the European (and domestic) public procurement regime.

The paramount implication of not classifying privately-financed projects as public debt could be that such purchasing would not fall under the annual comprehensive spending review of the government. In fact, non-inclusion of PFI deals in the PSBR could transform the structure of public markets by reversing the roles and the relative importance of the demand and supply sides. Indeed, it was originally suggested that the private sector should initiate demand by exploring the overall potential and delivery options and then introducing the plan to the relevant public authority. Such a scenario could also mean the dismantling of public markets and the elevation of private markets as the forum for the pursuit of public interest.

However, the practice not to include PFI projects in the PSBR balance sheet and the assumption that the relevant spending does not represent public debt were often described as legal and policy acrobatisms. The Public Accounts Parliamentary Committee and the Accounting Standards Board (ASB) took different views with HM Treasury over the issue of excluding PFI deals from the PSBR. In its December 1997 report, the ASB came out in favour of including PFI projects in the PSBR, although the Treasury, backed by the National Audit Office and the Audit Commission had issued guidelines to the contrary.

A serious set back for the PFI in the UK was the report of the ASB (*The Tweedie Report,* September 1998) which criticised the practice of the Treasury of not including PFI deals in the PSBR balance sheet. The report condemned such practices and urged the government, for the sake of legal certainty and good public sector management and accounting, to issue new guidelines for future PFI projects and treat them in the same way as traditional public procurement spending.

PROCEDURAL DELIVERY

Privately-financed projects have two constituent elements which are prerequisites for their successful completion:

(1) a genuine allocation of contractual risk; and

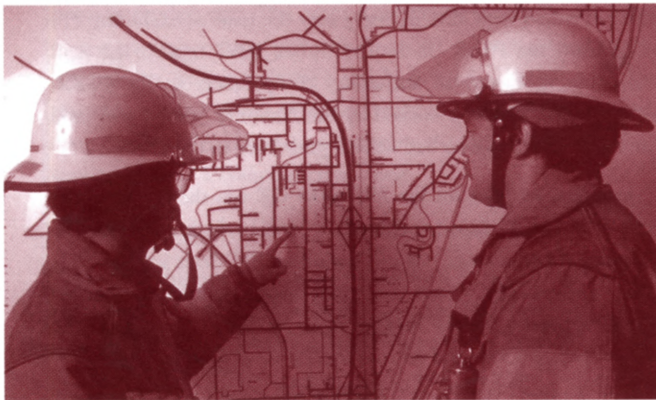
(2) value for money for the public sector.

The first element represents the integral balance of contractual relationships. Rightly or wrongly, under traditional public procurement transactions there is a widespread assumption that contractual relationships are based upon a

disproportionate risk allocation amongst the parties. Although in traditional public procurement systems the demand side appears the dominant part in the equation, when it comes to risk allocation, the roles appear reversed. Risk allocation is a much-misunderstood concept in contractual relationships in general, but particularly in public purchasing transactions, it has never been properly addressed. Normally, in a public contract, risk assessment includes contractual elements which are associated with the design or construction of a project, the required investment and financing, planning and operational matters, maintenance, residualisation, obsolescence, political/legal aspects, industrial relations, usage volumes and, finally, currency transactions. Risk allocation is the result of negotiations between the parties and is normally expected to reflect the pricing element of contractual arrangements between them. Thus, risk and pricing operate in an analogous relation within a contract. The more risk a party assumes, the higher the price to be paid by the other party, and vice versa.

In traditional public procurement transactions the demand side inevitably undertakes too much risk as a result of its practices. The award of publicly-funded contracts takes place predominately by reference to *the lowest price,* which constitutes one of the two permissible award criteria under the procurement rules (the other being the criterion of *the most economically advantageous offer*). When contracting authorities award their contracts by reference to pricing, this would normally reflect the amount of risk they are prepared to assume.

There is no golden rule as to what represents an acceptable risk transfer in a contract, the latter being private or public, for risk allocation primarily reflects the parties' perception of a transaction with reference to their own criteria. These criteria are often influenced by a range of parameters such as speculation, fear, certainty, as well as by a number of qualitative attributes of the parties, e.g. sound forecast and planning, market intelligence.



On the other hand, value for money as the second constituent element of a privately-financed project should reflect a benchmarked comparison between public and privately-financed models of service delivery. The comparison should not only take into account factors such as quality or technical merit, but mainly aspects of sound supply chain management reflecting efficiency gains, in the sense that the conclusion of a privately-financed project would resemble to a large extent a contractual arrangement between private parties. Value for money as an element in a PFI deal is a precursor of best purchasing practice by contracting authorities and also reflects the underlying competitive elements which are necessary in order to meet the accountability and transparency standards and principles. In its policy statement *Public Sector Comparators and Value for Money,* February 1998, the HM Treasury Taskforce has set out the role of comparators in public procurement, stressing the importance of the value for money principle. The comparators are indices which help to distinguish between the lowest cost and the best value for money for public authorities and also their use as an exercise of financial management and a means of demonstrating savings to public authorities.

EUROPEAN PUBLIC PROCUREMENT DIRECTIVES

The PFI is proclaimed to be an evolution in the public sector management and a step forward in achieving real value for money in public purchasing. Numerous guidance notes have been issued by government departments in an attempt to provide for a framework of smooth procedural delivery. However, a number of difficult issues arise when a privately-financed contract is examined under the spectrum of the European public procurement directives. Notwithstanding the fact that a PFI project is privately-financed, it will be paid for from public funds, thus compliance with the European public procurement rules is of paramount importance. It would be naive for contracting authorities to ignore the spirit and the wording of the directives. It could also be embarrassing for them if litigation before domestic courts or the European Court of Justice concerning the award procedures of a privately-financed project is initiated. Clearly, there is a great deal of uncertainty in relation to the compatibility of the European public procurement rules and the PFI. The situation has not yet been clarified by the European Commission, which seems to sit in the background waiting for the domestic government to determine any issues of compatibility.

It appears that three major issues in a privately-financed project may cause considerable friction between the European Commission and contracting authorities. The first relates to the contractual nature of the privately-financed transaction, when viewed through the spectrum of the European public procurement directives. A privately-financed project can be classified as a 'public services contract' or as a 'public works contract' depending upon the nature of the deliverables. It could also be considered as a 'mixed contract', where both services and construction work are parts of the project. Finally, it can be characterised as a 'concession contract'. The contractual nature of a PFI project is crucial in its procedural delivery and detrimental in complying with the relevant European procurement rules, as it triggers the applicability of different directives and requirements stipulated therein.

The second issue is concerned with the process of contract award and, in particular the type of procedures that contracting authorities may use in order to concluded a privately-financed project. When contracting authorities award PFI projects classified as public works or public services contracts, they have been urged to have recourse to negotiated procedures. The official line adopted is that a privately-financed project could meet all the conditions imposed by the European public procurement rules for allowing the *negotiated procedures* to be used in contract awards and form a sort of precedent for future projects. However, it should be pointed out that the European institutions never looked favourably at the use of negotiated

procedures by contracting authorities. The European Court of Justice has always been very reluctant in accepting the use of negotiated procedures, particularly without prior advertisement, and has always maintained their exceptional character.

Finally, the third issue revolves around publicity requirements. The European public procurement directives have established a regime which, inter alia, provides a mechanism for all the information needed to be made available to the relevant parties or the public in relation to the award of public contracts. Contracting authorities are under explicit obligation to furnish a range of information on their own initiative or upon request. This obligation is, in principle, extended to all PFI projects that are awarded under the procurement rules. However, practice has shown that very little information concerning the award of a PFI contract sees the light of publicity, often being described as 'commercially confidential'. The proposed Freedom of Information A*ct* in the UK has implications for the publicity of PFI contracts, implications which mirror the obligations of contracting authorities stipulated in the public procurement directives. An exemption for confidentially commercial information will apply, provided *substantial harm* to a party can be demonstrated.

CONCLUSION

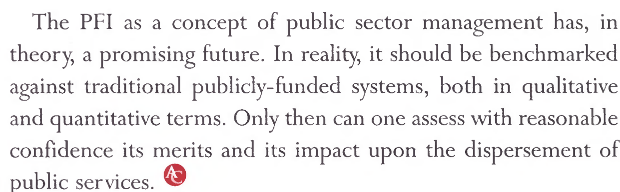
The PFI represents a genuine attempt to introduce the concept of *contractualised governance* in the delivery of public services. The PFI can be described as an institutionalised mechanism in engaging the private sector in the delivery of public services, not only through the financing but mainly through the operation of assets. The private sector assumes a direct responsibility in serving the public interest, as part of its contractual obligations vis-à-vis the public sector. The motive and the intention behind such an approach focus on the benefits which would follow as a result of the private sector's involvement in the delivery of public services. Efficiency gains, qualitative improvement, innovation, value for money and flexibility appear as the most important ones, whereas an overall better allocation of public capital resources sums up the advantages of privately-financed projects.

The PFI brings an end to the notion of public ownership and instead introduces the concept of service delivery in the relevant contractual relationship between private and public sectors. The private sector is no longer a contractor to the public sector but rather a partner. It seems that there is a quasi-agency relationship between the private and public sectors, in the sense that the former provides the relevant infrastructure and in fact delivers public services on behalf of the latter.

The PFI should be delivered through a system that guarantees accountability, openness and competitiveness. Such a system for the dispersement of public services is encapsulated in the European public procurement regime, which is expected to be the most appropriate delivery process for the PFI. The European public procurement directives provide for a disciplined, transparent and relatively swift system for the award of public contracts. One the most notorious features of the existing PFI delivery process is the abysmally lengthy negotiation stage and the prolonged pre-contractual arrangements. The average PFI gestation period is 18 months compared with two months in traditional public procurement contracts.

What remains is the development of comprehensive guidelines for the deployment of private finances in the delivery of public services and the embedment of relevant legislation that empowers public authorities to contractualise their governance. Prior to 1997 there was considerable uncertainty as to the legal position of the parties to a privately-financed project. The relevant legislation did not provide *in concreto* for the rights and obligations of the private sector and threatened with ultra vires agreements concluded between certain public authorities (local authorities and health trusts) and the private sector. It was unclear whether these authorities had explicit or implied powers to enter into such contracts, a situation which left privately-financed transactions in limbo. As a consequence, the *National Health Service (Private Finance) Act* 1997 and the *Local Government Act (Contracts)* 1997 have been enacted in order to clear all legal obstacles. Both acts have introduced a 'clearance system' where the relevant authorities must certify a prospective PFI deal with the government, checking not only its *vires* but the whole commercial viability and procedural delivery mechanism of a privately-financed contract.

The PFI as a concept of public sector management has, in theory, a promising future. In reality, it should be benchmarked against traditional publicly-funded systems, both in qualitative and quantitative terms. Only then can one assess with reasonable confidence its merits and its impact upon the dispersement of public services.



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CCH -*the* tax solution

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