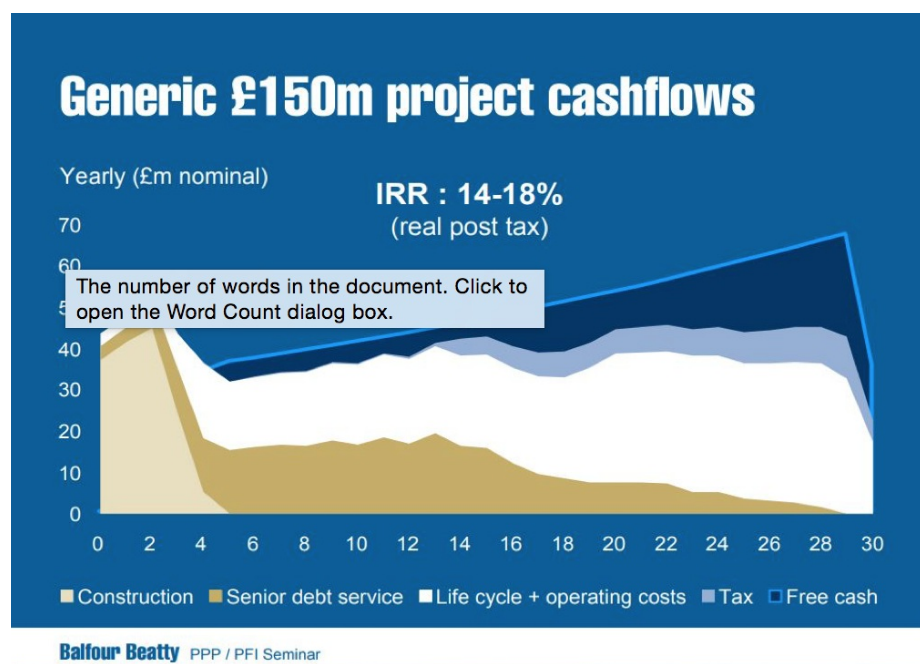
How and why the State's purchasing power should be used to renegotiate PFI deals

*If used appropriately, the state's purchasing power could result in new terms and a better deal for taxpayers when it comes to the government's PFI contracts. The **CHPI research team** explain why it is necessary to renegotiate and how this may be done in order to limit the leakage of profits and avoid additional upfront costs of buyouts.*

A Smith Institute report recently set out a "progressive" programme to reset the relationship between government and the private sector when delivering public services. The report recommends introducing new accountability requirements for private contractors – such as the need for open book accounting and for the introduction of profit caps. These are viable proposals for ensuring that future government to business contracting prioritises the public interest and places business under a duty to adhere to the same levels of accountability as public bodies. It recognises that the government has the ability and, some may say, the duty to impose requirements on companies which are delivering vital public services.

However, these proposals do not deal with the existing legacy of PFI contracts and other public private partnerships – and in particular, with the amount of scarce public resources which will "leak" out of the public sector and into the profit accounts of PFI companies over the next 15 or 20 years. In the NHS alone PFI companies are likely to make pre-tax profits just short of £1 billion over the next 5 years. To put this in perspective, it is almost a quarter of the new money which the government proposes to give the NHS over this period. And this relates only to 107 PFI contracts out of the existing 700 or so PFI deals which are currently in operation across the public sector.

The graph below from one of the earlier PFI contractors, Balfour Beatty, shows, the leakage of taxpayer funds straight into PFI profit is likely to grow over the coming years, making a resolution of this problem even more pressing.



This is because the financing of PFI deals is structured in the following way: the PFI company borrows the money upfront to build a hospital; once the hospital is built the public sector starts paying a unitary charge to use it over a 25-30-year period. Out of this unitary charge the PFI company pays back the lenders and whatever tax charges are required. As the debt is paid off over the course of the contract the amount left over is for the shareholders in the PFI company to keep (shown in the graph as "free cash"). So towards the end of the contract, (in many cases in 10 to 15 years from now) a significant proportion of the money which is being paid by the NHS for PFI hospitals will leak out straight to shareholder profits.

The debt element of these schemes is also an issue. We know from the National Audit Office that currently around half of the £10bn annual payments which are made to PFI companies goes to pay back the banks and other senior lenders to the scheme. And we also know from the NAO report that the amount the taxpayer is paying for this type of borrowing is around 4% higher than if the state had borrowed the money itself. So in addition to the excessive profit rates, the taxpayer is locked into a hire purchase arrangement which will continue to place an unnecessary burden on public expenditure for decades to come.

So what can be done to address the existing legacy of PFI? The wriggle room on these deals is limited and this was a deliberate part of the original PFI policy. When government struck the original deals, it was so keen to develop arrangements that both kept the projects off the balance sheet and incentivised the private sector to put up the cash that it minimised any risks to investors.

To start with, it absolved the investors of any demand risk – so that even if the public sector no longer has the need for the school or hospital, the PFI company still gets paid. As the NAO report shows, Liverpool City Council is paying £4million a year for a school which it no longer needs and which stands empty, at a total cost of £47m.

The government also passed legislation to guarantee that the state would continue to meet the payments if public sector bodies – such as NHS trusts – went bankrupt and were unable to pay the bills, effectively 'sheltering' PFI companies from the impact of austerity.

Most importantly, the government removed the risk to the investors of contract termination or a change of heart by an incoming government: the standard Direct Lender agreement sets out the levels of compensation which PFI lenders are entitled to in the event the public sector wants to terminate the contract. And as the NAO shows, on top of having to pay off the lenders and shareholders for their losses the public sector would also have to buy out the interest rate "swaps" – the financial instruments used by PFI companies to protect against the possibility of interest rate rises on the sums they have borrowed to fund the projects. Since interest rates have fallen, the public sector would be required to pay an additional £2.3 billion just to buy out the "swaps" on £10bn worth of PFI deals.

So what tools are left in the government's box to deal with this legacy? In theory, Parliament could seek to requisition or expropriate the assets of the PFI companies without providing any compensation and cease all payments to them. But this extreme move would almost certainly be challenged in the courts both domestically and internationally. In addition, it would almost certainly mean a significant rise in the risk premium on all government borrowing, with serious consequences for the government's freedom of action across the board.

The government could also buy out the contracts and pay compensation to the lenders and the shareholders at the rates required by the Direct Lenders Agreement. Quite why any government would commit scarce public funds to providing a lump sum to banks and shareholders when the NHS and other public services are in need of a large injection of cash is unclear.

However, one can only assume that the PFI companies would be delighted to receive an upfront return on their investment on a completely risk free basis. And, as the NAO points out, there would still be a need to employ the workforce and buy the machinery and equipment to carry on running and maintaining the hospitals and schools. So extra funding would be needed to cover these costs.

Whilst the PFI companies appear to have locked out any potential downsides to these contracts, the state still wields a significant amount of power as the sole purchaser of these services. Instead of considering termination or nationalisation, policy-makers should plan to use their power and enter into new bargains with the small number of equity investors and lenders who own the vast majority of individual PFI companies.

A number of suggestions have been put forward along these lines. For example, CHPI's Colin Leys has suggested that in order to encourage a re-negotiation of the contracts across the board, Labour could signal that none of the companies which currently own PFI companies could expect to receive any business from a future Labour government if they refuse to renegotiate the terms of the PFI contracts. The NAO has suggested that the state may wish to buy up equity stakes in PFI contracts in order to force the re-financing of these deals, although this would mean equity holders being willing to sell their highly lucrative shares.

John McDonnell MP, the Shadow Chancellor, has signalled that it might be possible to legislate to prevent the offshore owners of some PFI companies receiving their dividends, presumably through tax measures. Labour backbencher Stella Creasy has called for a "windfall tax" on PFI profits. This is in part to claw back the windfall gains which PFI companies have made from the reduction in corporation tax from 30% when the deals were signed to 17% by 2020 – gains which our research shows are likely to net NHS PFI companies around £190m on top of their already excessive returns.

In the first instance, tax policies of this nature could potentially recoup much-needed tax revenues, which could be used to fund the growing NHS deficit. But more importantly, the threat of imposing a tax of the type talked about by McDonnell and Creasy could be used as a bargaining chip by government to bring the PFI companies to the table to re-negotiate the existing deals. And whilst investment analysts have few concerns about the termination of PFI deals, because of the compensation clauses in the contract, they view the notion of a tax on profits as a "credible threat".

For many people the idea of re-negotiation is unpalatable, given the extent to which PFI companies have "fleeced" the taxpayer for many years. However, exploiting the government's advantage as the sole purchaser of services and payer of private sector debts should not be seen as a capitulation. If used appropriately it should be possible to dictate new terms to PFI companies to get a better deal for taxpayers, to limit the leakage of profits and to avoid any additional upfront costs of buyouts which taxpayers can ill afford.

———

About the Authors
This was written by the **CHPI research team**.

All articles posted on this blog give the views of the author(s), and not the position of LSE British Politics and Policy, nor of the London School of Economics and Political Science. Featured image credit: Pixabay/Public Domain.