

THE PRIVATE FINANCE INITIATIVE: PRIVATE OPPORTUNITY AT THE PUBLIC'S COST?

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INTRODUCTION

The aim of this article is to review the experience of major Private Finance Initiative (PFI) funded projects in Scotland to date. There are several lessons that can be learnt, and should be considered if PFI as a policy is to continue. The underlying problems that gave rise to the development of PFI still exist and will challenge the new Scottish Parliament.

In the 1980s the Conservative government sought to mobilise private sector financial resources, and the white paper **Private Finance in Public Expenditure** (HM Treasury 1988) started the process. The Private Finance Initiative was launched in 1992. Its stated aim was to form a private-public sector partnership, in order to enable the private sector to enter the domain previously regarded as intrinsically public. It was hoped that PFI would secure new business opportunities for the private sector and achieve economies in the delivery of public services:

The private finance initiative is a partnership between the public and private sectors. The public sector gets better value for services, the

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private sector gets the business opportunities.
(Ken Clarke, Chancellor of the Exchequer, 1996)

These economies were assumed to exist on the grounds that the private sector was more efficient at allocating resources, and had less bureaucratic 'drag'. The policy enabled the UK government to secure new sources of finance to fund capital projects for public sector services. This route of funding removed capital expenditure from the public sector borrowing requirement, incidentally helping the government meet the stringent targets of the Maastricht agreement on monetary union. It also provided public sector managers with a new-found ability to manipulate commercial and management practices previously held to be exclusively for private sector use.

PFI is a revolution in the provision of public services. It is transforming the public sector from being an owner of assets to a purchaser of services.
(Ken Clarke, Chancellor of the Exchequer, 1996)

The PFI now encompasses not only ownership by the private sector of capital assets but also the private sector providing services for public sector use, changing the nature of public sector provision. The Conservative government continually refined its policy to promote the Initiative (Clarke 1996; Gray 1997; HM Treasury 1988, 1993, 1995, 1996).

Proponents of the Private Finance Initiative identify gains for all stakeholders. These include increased business opportunities in new markets for the private sector, together with access to high quality, modern facilities for the public which may otherwise not materialise given limited 'traditional' capital funding. The Conservative government stated that the driving force behind the Initiative's introduction was the 'public benefit' of better quality, cost-effective services at a lower cost to the public than pursuing capital projects under the traditional route could provide (HM Treasury 1995).

In addition, it was suggested that 'value for money' would be gained for both the public purse and the user as a result of having access to proficient private sector management. The Conservative government attempted to control public expenditure and hold down the Public Sector Borrowing Requirement (PSBR) with mixed success. The new Labour administration has chosen to retain control of PSBR as a primary aim of economic policy. Another benefit of the PFI was to transfer risk from the public sector to the private sector. Again, an underlying assertion in the PFI white paper was that the private sector had a more fully developed risk management strategy. Therefore transferring risk analysis and management to the private sector was intended to improve risk identification and management. As the private sector was

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alleged to be more risk aware, that fact would provide increased incentives for private sector managers. The main risks intended for transfer were overrun costs due to project problems or incomplete project specifications; and costs associated with the risk of project failure:

Getting more for the taxpayers money through the delivery of specific services at a specific time, to specific standards rather than the cost overruns and subsequent defects so typical of old fashioned public work schemes. The PFI and its partnership with private business will grow and is here to stay.

(Michael Jack, Financial Secretary to the Treasury with responsibility for PFI, 1995)

These two underlying principles must be present in any PFI project. For the public sector, risk transfer would transfer cost overruns to the private sector. Overall cost-efficiency was to be delivered through the private sector's superiority in design and management, with the inclusion of the profit motive incentive to ensure on-time delivery, and the competitive element ensuring best value to the taxpayer (**Public Finance** January-March, 1996).

The PFI may be categorised into three project types: financially free standing; joint ventures; and services sold to the public sector. In each type the private sector assumes financial risk and overall project control to varying degrees (HM Treasury 1995). In financially free standing projects, the private sector commits itself to the project on the basis that costs will be recouped through charges to the ultimate user. The public sectors' contribution is limited to enabling the project to go ahead by undertaking initial planning, providing ancillary works or assisting with statutory procedures. Joint ventures pass project control to the private sector, but share project funding with the public sector. This may be because wider social benefits accrue from the project that cannot be 'captured' by commercial revenue, or because the return generated may be over a considerable timescale. Services can be provided to the public sector. The cost of such projects is covered by charges from the private sector provider to the public sector organisation which let the contract.

The following three case studies illustrate the three types of project identified. They highlight a range of problems associated with PFI. The article also attempts to point out implications for future public service provision. Some problems have been or are in the process of being addressed. Using the Kenneth Clarke test, the article goes on to consider whether PFI has been successful, i.e. if both value for money and risk transfer have actually been achieved.

THE SKYE BRIDGE

This is an example of a financially free standing PFI project. Transport services have traditionally offered lucrative investment opportunities for the private sector, and it was 'fortuitous' for the last administration that the first PFI project in Scotland was the Skye bridge (**The Scotsman** 23 December 1989). This project was seen as financially free standing with the potential for profit through charges to final users. Under this type of project the government role is limited to that of enabler and regulator, with the private sector assuming all financial risk associated with the design, building, constructing and operating of a project (HM Treasury 1995).

The Skye Bridge opened in November 1995, at a cost of £23 million. It was intended as 'the solution to a traffic congestion problem caused by the inability of the existing ferry service to accommodate the 500,000 vehicles using its services' (**Financial Times** 24 May 1997).

Causing continuing controversy, the Skye Bridge was funded through the PFI, with the investment being recouped by way of toll charges to users, and the government granting a 27 year concessionary period to the successful consortium, Miller-Dywidag. After negotiations the consortium secured a longer concessionary period than had at first been proposed. It was claimed that this was to compensate for acceptance that toll charges to users would not be dearer than the previous ferry service vehicle charges. In addition the consortium was given permission to raise tolls. If the bridge traffic fell below 1990 levels the tolls were to be allowed to rise by up to 30% in real terms. A 9% rise in total toll income over the life time of the concession was also allowed. Miller-Dywidag will receive an estimated £10 million profit at 1991 prices, a real rate of return of 18.4% (BMA 1997, NAO 1997a, and our own calculations).

This was seen by some observers to be an attractive investment opportunity with no observable risk (e.g. **Financial Times** 23 May 1997). Many Skye residents responded to the introduction of toll charges by a refusal to pay, arguing that the only road link to the mainland should be mainly funded by normal tax payments. The ensuing court cases have been complex and controversial. This sort of refusal would normally be dealt with by civil proceedings but criminal charges have been brought. Court rulings have been reversed on appeal because of a lack of clarity in legislation as to whom in a vehicle is responsible for the toll payment. The appeal court declared that the legislation was specific, and non-payment remains a criminal offence. The Bridge protesters plan to go to the European courts declaring the tolls are a

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breach of human rights. In so doing, they will provide a clear signal to private partners that legal uncertainty increases residual risk.

The achievement of value for money is far from clear. Bridge users (also members of the tax paying public) perceive they are paying twice for a service, once through taxation and once through toll charges. Although not according with economists' views on the nature of charging for a public good, it is not unusual for charges to be levied on the users of bridges. This is seen as justifiable given the 'local' benefit in contrast to the general nature of taxation. The PFI gain would occur if provision was at a lesser overall cost. Comparison of Skye Bridge charges with other UK tolled bridges provides some guidance on value for money. It also provides an insight into previous public policy on the balance between local gain (recouped by bridge charges) and wider public benefit (the balance of tax input). Toll charges that range from £0.05 (Swinford Bridge) to £3.70 (westbound only charge on the Severn Bridge) look modest in comparison with the £4.30 (single) winter charge and £5.20 (single) summer charge for the Skye Bridge (**Public Finance** 28 June 1996). If the PFI boasts of securing lower cost provision, it may be expected that charges would reflect this and be on a par with other bridges - especially the Dartford and Severn Bridges both built using private finance. The Scottish Office, in providing ancillary services (mainly roads) for the bridge, exceeded its estimated cost of £6 million at 1988 prices by 48%. (British Medical Association June 1997). Cost to the public purse rose to £11.2 million at 1988 prices as a result of design changes, the need to compensate the consortium for delays to the project as a result of a public enquiry, and other costs (including adviser's fees of £2.3 million) (NAO 1997a).

There is considerable doubt as to the risk the private sector assumed in reality. Given the relatively straightforward nature of the design and engineering problems, within this project most risk relates to the failure of demand and possible competition. The granting of a concessionary period allows the private consortium to be protected from competitive tender while it recovers its investment. The period is to be extended if it is insufficient to recover all investment costs, and the ability to raise toll charges if demand falls has been granted. The National Audit Office's report criticised the 'significant financial concessions' given to the consortium. A report by the National Audit Office (1997a) examining the project criticised the Scottish Office for its failure to undertake a systematic comparison of the alternative congestion solution - upgrading the existing ferry service provision. As a result, the most critical question of all in any PFI deal - is it genuinely good value for the public purse? - is one the audit office has found itself unable to answer.

The bridge is now the only route for traffic to the mainland, as the profitable Caledonian MacBrayne ferry service was withdrawn on the day the Bridge opened under Scottish Office instructions. To avoid toll charges, local businessmen considered providing a car ferry service, only to be informed that they would not be granted 'ferry rights' (**Public Finance** 8 March and 28 June 1996). The Office of Fair Trading subsequently informed the businessmen that no such rights are required. Such events show the determined attitude of the government to assure the project's success, bringing criticism from some quarters that it has abused its role as enabler to the point of actively encouraging monopoly provision to assure the private consortium was adequately protected from demand risk and, therefore, able to secure its return on investment (**Public Finance** 19 January 1996).

The criminal charges imposed on non-payment may be viewed as underlining the government commitment to secure the private consortium's investment, its own contractual responsibilities and its determination to enable PFI to succeed. The private sector has to await the court's response to assess whether risks to the private sector can be altered unpredictably making investment in future PFI projects less worthy of consideration. The government may be liable to the private consortium for failure to fulfil its contract and enforce charges. Either such a ruling will act as a lesson for all would be PFI private sector partners, and make it increasingly difficult to find private sector investors, or the government would have to 'pick up the tab'.

Outwith the legality of charging, the private consortium does not assume financial risk as measures are implemented to ensure that adequate demand is secured (with demand risk ultimately lying with the bridge users). The toll of £4.90 is not immediate evidence of customer value. The bridge scheme has a debt repayment schedule that is 'front end loaded'. That is, it repays the initial investment far quicker than has been thought prudent for public sector capital investment to date. That the whole cost of the actual bridge with its attendant interest rate charges will be recouped 'locally', i.e. from the users, suggests that the state sees no benefits for the wider economy. This suggests that where the private sector identifies risk, it seeks to pass that risk on to the user through charges.

NEW SCOTTISH AIR TRAFFIC CENTRE

This is an example of a 'joint venture' PFI project, the second type identified. This is a joint venture between the Government and the private sector. The private sector should be the 'lead' partner, and, according to Treasury guidelines, risk must clearly transfer to the private sector (HM Treasury

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1995). The National Air Traffic Services provides air traffic control for the UK from two centres: New En-Route Centre (NERC) and New Scottish Centre (NSC)

NERC moved to new premises in 1995 funded through public expenditure. Its software integration problems had postponed the already delayed project for a further three and a half years. The New Scottish Centre (NSC) is located in Ayrshire and needs rehousing and updating of its systems. The NSC's new premises were to be financed through PFI. The government stated that the £200m building cost (and the £600m ongoing investment) could not be afforded without increasing government borrowing (Department of Transport report December 1996). Capital expenditure permission given to the National air traffic services had been reduced in proportion to the capital it was believed PFI would generate.

The Civil Aviation Authority has suggested that PFI was not the correct route for such provision. It expressed concern that the successful private consortium may be unwilling to commit to the essential ongoing investment such a safety-critical industry requires. Some have suggested that PFI would lead to the fragmentation of provision, with the ultimate costs born by users if safety is compromised. Simultaneously, the speculation over the future of National Air Traffic Services (i.e. its possible privatisation), and fears that NERC would be left to service the UK on its own making NSC redundant, caused concern for the Service and investors alike. These worries and the ever-changing specification of the project resulted in little interest from private finance. PFI approval was six months later than initially intended. Difficulty in setting out the ground rules for the bids could have been foreseen given the unique public good nature of the service being set up for tender. Protecting the ongoing public service aspect of an enterprise whose chief duty is co-ordination and safety requires some care. Taken together with the financial and political implications of any operational failure, these complexities suggest that setting up contract construction, monitoring and enforcement procedures would be time-consuming and expensive. The tendering costs amounted to approximately £5m to each of the two bidders.

Because this was a financially free standing project under the PFI, the successful bidder had the prospect of a 25 year concession, recouping its costs through air space charges to airlines and thence to the travelling public. Delay in a project's operation diminishes its profit potential and viability. Delays in public permission add enormously to costs and will be absorbed in pricing, or a reduction in quality, and ultimately borne by the public. An inevitable concern for National Air Traffic Services is that additional costs may be absorbed by reducing quality to the point where lives are lost.

Operationally, National Air Traffic Services would continue to run the service and carry liability for failure.

Another feature of these processes is that the initial public expenditure saving is replaced by larger, less flexible spending commitments. Over these Stephen Dorrell, then Secretary of State for Health, suggested the government did not have or need controls in place to ensure ongoing value for money in a PFI project:

So long as there is a level playing field, there is a competitive process, there is therefore the mechanism in place to ensure value for money.
(6th Report of House of Commons select committee, HM Treasury 1996)

With no competition outside the tendering process, there is at least doubt about continuing value for money. Brian Donohoe, Labour MP and a member of the Transport Select Committee, was quoted as saying

Regarding the proposed use of the PFI to fund the NSC and Oceanic Equipment upgrade for air traffic control at Prestwick - the use of the PFI would in fact add around £30 million which is 10% of the total project cost.
(**Financial Times** 19 April 1996)

National Air Traffic Services itself was opposed to PFI for financing the project unless no alternative funding was available. The government claimed that PFI for the project was additional in the sense that without it NSC could not be financed. The European Union, at least in the person of Neil Kinnock, stated in 1996 that NSC appeared on the face of it suitable and eligible for European aid, but it would not be considered unless the UK government submitted an application, with matching UK public funding. PFI was presented by the Government as the only funding available for this project. This suggests at least one extra drive behind government policy, the Public Sector Borrowing Requirement. It has also been suggested that by creating smaller less structurally integrated services, provision may be easier to privatise.

Given the highly charged atmosphere surrounding PFI and this project in particular, most risk for the private consortium would appear to be 'political'. With the future of NSC unsure, neither business nor investors are likely to proceed unless it can safeguard its investment by way of compensation as it has no control over government policy. The NSC's PFI contract contains the clause:

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The legal and financial status of [National Air Traffic Services] is currently under review by the government. Any change in this status, e.g. privatisation, might put [National Air Traffic Services] in a position where it would want to assume full responsibility for NSC. The project company should be aware that, in this event, the CAA could invoke a termination clause in the agreement but would pay appropriate compensation to the project company in such circumstances.
(Invitation to Participate, CAA)

This shows deep confusion over the reasoning behind the pursuit of two conflicting policies. The government is setting itself up to pay in several ways because of this conflict - most straightforwardly, in compensation to the companies for the PFI tendering process and for cancelled contracts. In addition, it must expect a reduction in the 'market price' of the PFI opportunity given the need to discount an additional 'risk premium' while future privatisation remains a possibility (companies offering lower benefits and higher charges than would otherwise be the case). As with the Skye Bridge example the transfer of financial risk to the private sector in these projects remains problematic.

Concerns exist that users will bear costs incurred by delays and expensive tendering for this project. The admission that there is no institutional check that PFI offers the public ongoing value is also worrying. The failure of the UK government to seek European aid is questionable in value-for-money terms. These added to the possibility of the total risk associated with the project increasing (no matter to whom that risk falls), and call into question the public gain of PFI funding for this project.

NATIONAL INSURANCE RECORDING SYSTEM

This scheme is an example of the third type identified, i.e. a project sold to the private sector with a service leasing arrangement. Again, risk must be seen to transfer to the public sector. The National Insurance Recording System upgrading was approved for PFI. The project was to provide up-to-date equipment, the purchase of which was partially necessitated by legislative changes. The private sector consortium investment is recouped through charges to the state for use of assets that the consortium owns and maintains. At the end of the contract period the government may invite tenders for a subsequent contract. Should the existing lessor lose the contract the successful bidder may purchase the assets from the original consortium and then proceed to lease assets and services to the government. Should the successful bidder have alternative provision in place the original asset is the

responsibility of the original consortium. (HM Treasury 1995). As the assets are not owned by the public sector, the government may be left in a position where it has no means of providing this service should the consortium gain a higher price elsewhere for its assets at the end of a contract period. The economic theory of specific assets (see for example Williamson and Riordan 1985) predicts that the consortium has an incentive to compromise on quality or service by making the asset less specific and tailored to the public-specific purpose. In protecting its investment from being too specific in purpose, the owner is seeking to increase its resale value, and, by widening the pool of potential customers, to maintain a credible threat of service withdrawal.

The successful bid from Anderson of £134 million was described as 'strikingly good value' (NAO 1997b; **The Times** 29 May 1997). Given that the other two private sector bids were £214 million and £235 million, and that the publicly funded alternative was estimated at £320 million, this judgement does not seem unreasonable. In addition, (under the terms of the contract) Anderson was obliged to pay £12 million to the government for delay in implementing the service. It also appears to be the case that more than £10 million more than the originally estimated cost is being carried by Anderson because the size and complexity of the work was greater than originally expected and several old systems have to be kept running in tandem (NAO 1997b).

The transfer of the estimating risk appears successful. Also, payment for the non existence of the service indicates at least partially successful contract construction and enforcement. However, the process is not a one stage 'game' but a 'repeated game'. The incumbent may be in a position to claim a 'claw back' at the repeated bid stage. Further, the accurate assessment of cost may have been calculated by one of the higher bidders. Gross underestimates either 'taken on the chin' or successfully returned by the private to the public sector could cause problems either at the repeat stage of one project or in the defensive reactions of the parties to other PFI projects

THE PFI ADVANTAGE

A great deal of the debate about PFI has centred around four assertions:

- ◀ the inevitable efficiency of the competitive private sector;
- ◀ the ability to transfer risk form the public to the private sector;
- ◀ the impossibility of government capital funding;

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- ◀ the clarity of management possible once purchaser and provider are separated.

The first is a deeply held belief on the part of the proponents of PFI, backed by a partial economic analysis and problematic observation, which it is beyond the scope of this paper to analyse completely. Nonetheless, on the degree of competition, the most that it is reasonable to expect is that these projects are 'contestable' given the limited number of permutations of firms that are large enough to deliver construction, engineering, management and finance for these projects. Once set up, the project operators appear to be unchangeable by the state 'purchaser' for some time. The Skye bridge is not contestable for 27 years, the NSC not for 25 years.

The projects considered in this paper are unusual. They have individual requirements and peculiarities which can make them difficult to appraise. By definition, large-scale one-off projects are common in the public sector, and as a result public finance estimation has a poor reputation. It seems likely that some of this approbation is unjustified. 'One off' projects are intensely difficult to cost. Large unique privately funded projects also have a history of massive cost over-runs, e.g. the channel tunnel. Traditionally this risk has been borne by the public sector. One of the purposes of PFI was to transfer this risk to the private contractor. Either way, in the long run, these costs are passed to the end user through taxes or charges. In an article in the **Financial Times** (18 June 1997) Adair Turner, Director-General of the Confederation of British Industry, defended the significant profits the private sector had made under PFI deals as just reward for the 'considerable risk' it assumes. This paper suggests that in at least two of the three cases examined the existence of political risk seems to have prompted the construction of long-term agreements with the private sector devoid of any normal commercial risk at all. In addition, the total 'quantity' of political risk is not minimised because the project is funded privately: the case of the air traffic control system shows that it can actually be increased. One of the 'risks' is the democratic process of decision making which is relatively slow and subject to reversal. The private sector is not well adapted to deal with this.

The constraints on government expenditure are imposed for sensible reasons, to reduce crowding out, and restrain borrowing. The accounting method adopted in the case of the UK Public Sector Borrowing Requirement is unique within EU public accounting. From an economic perspective, government borrowing to invest in social capital is viewed differently to borrowing for transfer payment provision (for example, social security payments). The peculiar minimisation of public capital investment is all the more worrying because the costs of raising private capital are greater than the

government experiences in financing service provision. The market recognises that capital borrowed by the UK government or 'state enterprises' is nearly riskless in terms of default. No private sector institution can borrow on these terms. For major banks the default premium as against the UK government may not be very great but a typical PFI consortium contains more than top rated banks. Even if the interest rate differential in favour of government borrowing is small in percentage terms, the capital involved may be very large, and so the additional cost may be significant. As pointed out in the case of the Skye bridge, the profile of repayment may not be ideal from a users' point of view. For PFI to give any benefit it has to more than overcome these capital cost handicaps.

Clarity of management is difficult to achieve given that each large project has unique features. The distinction between purchaser and provider can be difficult to maintain when the state is one of the parties to the arrangement.

According to the Institute for Fiscal Studies (IFS 3 July 1997), the Chancellor of the Exchequer Gordon Brown will need to make appreciable cuts in public spending over the next few years to meet his commitments to reduce public borrowing. An analysis of the Public Expenditure Survey projection over the next two financial years (1998/9 and 1999/2000) indicates a shift from public funding of capital expenditure to private finance through PFI.

A series of guidelines (**Public Finance** 27 June 1997) has been issued which draws attention to the NAO reports concerning the Skye Bridge and the National Insurance Recording System, suggesting that the recommendations made in these reports be noted by all departments. The guidelines also address one of the main problems for both public and private sector partners, namely a reduction in the contractual complexity and a standardisation of the tendering process, which should reduce bureaucracy and help keep costs down, and these recommendations have been echoed by several authors (Collins 1997; Hewitt 1997; McKabe and McKendrick 1997).

UNIQUE SCOTLAND?

There are still several problems facing new projects in Scotland. Much of the Scottish public sector faces under-funding problems, which will presumably worsen in the near future (**Public Finance** 15 March 1996, 5 April 1996 and 28 June 1996).

The Scottish Water industry (the public ownership of which is unique in Great Britain) desperately requires additional funding to help meet various EU directives concerning water quality and sewage disposal. To date, private

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sector partners have been very slow in coming forward, as the projects require large-scale capital investment before an income stream is generated. The annual reports of the three new water authorities claim that new projects are in the process of being reassessed, and in due course a new asset management programme will announce investment plans for the future. This ignores the fact that the industry is not new, but has merely been reorganised, and that capital expenditure plans from the previous water authorities demonstrate massive investment under funding.

A review of the annual accounts of the Scottish NHS trusts, the new water authorities, the Universities and the FE colleges all show projects which have been planned, and have received Scottish Office approval, but still require a private sector finance partner. The Government seems faced with the prospect of providing incentives (Scottish Office 1998b), through subsidy or acceptance of risk, either of which defeats the stated policy objectives of the initiative (**Public Finance** 8 March 1996). The new Labour administration has indicated that it will seek to review the funding of the Scottish public sector. There has been much debate of the Barnett formula and the mechanism for allocating resources to Scotland. If resources were to be allocated on a per capita basis equal to that in the rest of the UK it would mean a per capita reduction in allocation of UK resources for public spending in Scotland. To date, the government has ruled out significant changes to the Barnett formula, but it is an issue that is bound to resurface with the birth of the Scottish parliament.

If the commitments to public sector capital projects are to be met, additional funding will have to be found in Scotland (**Public Finance** 15 March, 5 April, and 28 June 1996). In a recent press release, Donald Dewar announced the signing of a deal for a new NHS hospital in Hairmyres, Lanarkshire, totalling £67.5 million. The press release also indicated that, as of the 1 April 1998, the total amount for capital projects out to tender or under negotiation was £1.08 billion, with a further £65 million advertised (Scottish Office 1998a). This represents a vast sum of identified capital expenditure as yet unsecured. Although the Scottish Parliament could use its tax raising powers to fund social capital projects through increased taxation and seek explicit, traditional, borrowing powers (currently denied to it by the provisions of the Scotland Bill), the scale of capital investment necessary in Scotland will pose unique problems for PFI.

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