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The use of Private Finance Initiative (PFI) Public Private Partnerships (PPPs) in Northern Ireland

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This report was commissioned by NIPSA
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Foreword

NIPSA has campaigned against the use of Private Finance Initiative (PFI) and Public Private Partnerships (PPPs) since these policies were first introduced by the Conservative Government in the 1990's. Despite the mounting evidence of PFI and PPP failures, however, the UK Government and the NI Executive continue to advocate the use of PFI/PPPs to provide essential public service infrastructure and deliver public services.

NIPSA therefore decided it was essential to provide Ministers, MLAs and the public in Northern Ireland with an independent and rigorous analysis of the use of PFI/PPPs in Northern Ireland. Professor Allyson Pollock's team at the University of Edinburgh was commissioned to undertake this work – the University's Centre for International Public Health Policy is widely recognised and respected as an expert authority on the issues involved.

We believe this is a landmark report on PFI/PPPs in Northern Ireland. It provides stark facts. The unitary charges to fund agreed and projected PFI/PPP schemes is going to cost a staggering £10 billion plus if the devolved administration adheres to current plans. These costs will have to be met from Northern Ireland's public expenditure budget. Public services will suffer not benefit as a consequence.

It is now time to stop PFI/PPPs in Northern Ireland. A switch back to conventional procurement for all future public capital projects can only help local companies in the current financial climate. As the report highlights, PFI/PPPs freeze out local companies in favour of large multinational corporations.

The Centre's report now provides the clear and compelling evidence for the change of policy on PFI/PPPs that is so desperately needed. NIPSA commends the report for detailed consideration by Northern Ireland's Ministers and MLAs.

JOHN COREY
General Secretary
NIPSA

Executive Summary

- The use of public private partnerships (PPPs) In Northern Ireland has dramatically increased since the late 1990s. As of March 2008, contracts for 35 PPP projects had been signed, representing private financing of £1.29 billion. A further 13 projects, with a capital value of £1.94 billion, are now being negotiated with private sector bidders and are due to sign before 2012.

- Private finance creates a public debt. The public bodies involved in PPPs have to pay annual payments to the private sector over a long period, often 30 years. The future payments on schemes signed to date amount to some £4.7 billion. As the projects currently in negotiation are signed off, the liabilities accruing to PPP contracts in Northern Ireland will rise to more than £10 billion.

- Different rationales have been used to support PPP in Northern Ireland in the last decade. The first devolved administration regarded PPP as a means of generating “additional” investment. However, this rationale was broadened during direct rule, when PPP (by now the “preferred” method for capital investment) was embraced as part of wider measures to reduce the size of the public sector.

- In fact, neither rationale is valid. The “additionality” of private finance is illusory – an accounting anomaly which distorts financing decisions. Similarly, the notion that PPP can help to rebalance the economy is a misconception. This is a policy that will channel work to large, overseas companies at the expense of domestic providers, curtailing private sector growth.

- In reality, the legitimacy of PPP stands or falls on its cost-efficiency credentials: i.e. whether the policy is better value than the alternatives, such as direct borrowing. The evidence demonstrates that finance costs are higher for the private sector, and this, combined with an excessive rate of return on capital, has led to very high costs for the public authorities involved in contracts.

- These costs are increasing for new schemes due to the credit crunch, which has eliminated bonds - the cheapest source of private finance - and significantly increased the margins on bank finance.

- New accounting regulations will address the anomaly whereby debt raised through a private sector intermediary is not recorded on the public sector’s balance sheet. This will remove the central attraction of PPP for the political parties of Northern Ireland. With devolution restored, there is a clear need for a full, independent review of capital investment policy in Northern Ireland.

Introduction

Under the Private Finance Initiative (PFI), the public sector enters into long-term contracts with private sector companies to design, build, finance and operate a new facility such as a hospital or school. The policy was introduced by the Conservative government in the autumn budget statement of 1992 and, since then, it has accounted for a significant proportion of large-scale investment projects in areas such as health, education, defence, transport, council housing, water infrastructure and waste management (HM Treasury 2008). As of March 2008, 627 PFI schemes had been signed in the United Kingdom, representing privately financed investment of £58.2 billion.

In Northern Ireland (NI), private finance has been used as a method of increasing investment in public services, which are widely perceived to have suffered from under-funding in recent decades. The use of PFI projects, or public private partnerships (PPPs) as they are more commonly known in NI, has increased since the late 1990s. As of March 2008, there were 35 PPP contracts signed in NI, providing private investment of £1.29 billion. A further 13 contracts, with a capital value of £1.94 billion, are being negotiated with private sector bidders and will be signed by 2012.

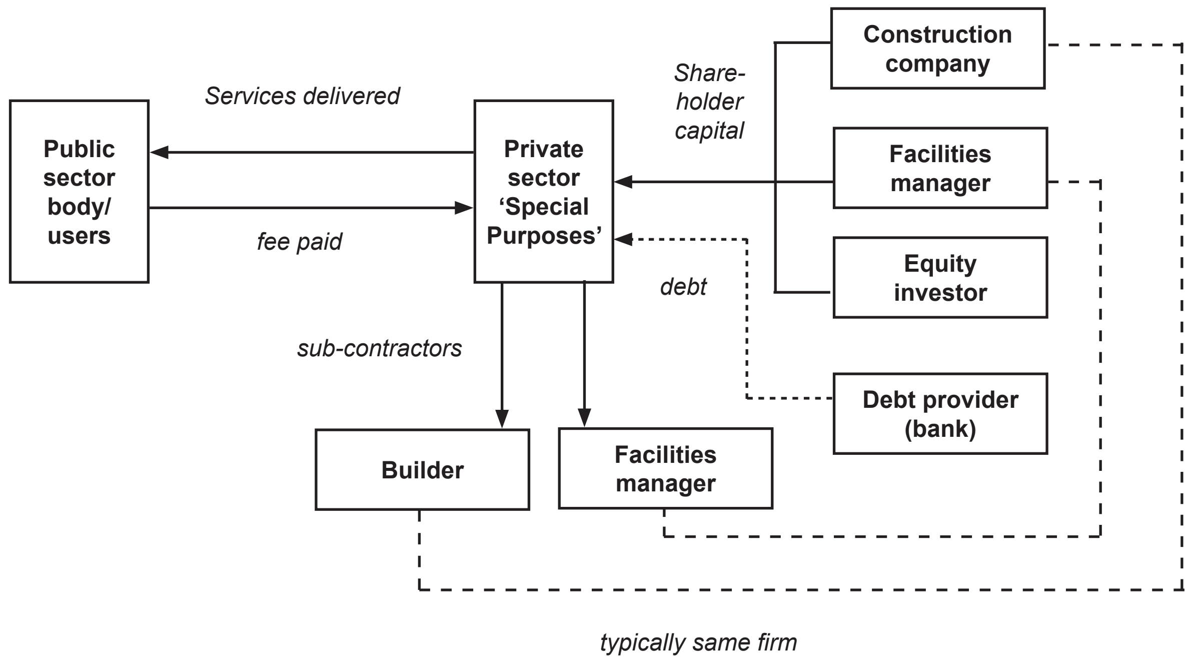
i. What is PPP?

A PPP is a long-term arrangement between a public authority and a group of private sector firms, in which the latter is responsible for financing the design and build of new facilities, and then providing certain services within them once the construction works are completed. For example, in a hospital PPP, an NHS body will contract with the private sector to design, build and finance a new hospital. Once the hospital building is delivered, the private operator will maintain the facility and deliver a range of “non-core” services - such as catering and cleaning - for a period of 25-30 years.

When undertaking a PPP, a public authority carries out a competitive procurement process, with a number of private consortia bidding against each other on the basis of price and quality to undertake the project. Each consortium involves a mix of investors, such as construction and facilities management companies and private equity institutions. On signing the contract for the project with the public authority, the members of the winning consortium create a “Special Purpose Vehicle” (SPV) - a new private sector business that exists solely to deliver the project.

The SPV enters into sub-contracts with one or more firms (usually its own shareholders) to deliver the project. Finance is also raised from the shareholders, and ‘senior debt’ is raised from banks or the capital markets. In the standard SPV financial structure, senior debt will provide 90% of the finance required, with loans and equity capital from the shareholders making up the remaining 10%. The public and private organisations involved in a typical PPP, their roles in the project and the financing arrangements between them, are illustrated in Figure 1 below.

Figure 1 The contractural structure of a typical PPP project



ii. Financing and funding in the public sector

While PPP provides *finance* for investment in new facilities and infrastructure in NI, it does not provide *funding*. It is a method of accessing capital, like direct borrowing and it creates a long-term funding requirement for the public sector in much the same way. Annual *unitary* charges must be paid throughout the length of the PPP contract, providing a return on the private sector's capital and fees for the services it provides. Thus, increasing investment through PPP requires an increase in funding – and this can only come from the UK Treasury, higher regional taxation or user charges.

However, under certain conditions, using PPP rather than borrowing directly can circumvent (often strict) constraints on capital investment, and this has been one of the central drivers behind its use.

This report provides an overview and an evaluation of the use of PPP in Northern Ireland. It is organised in three sections:

Section 1: illustrates the increasing significance of the PPP method in NI, along with the implications for future public expenditure.

Section 2: summarises the main developments in PPP policy in NI over the last decade, describing the embrace of a "limited" PPP programme by the devolved administration of 1999-2001; and the expansion of the policy and its rationales under the subsequent period of direct rule.

Section 3: provides an evaluation of PPP against the three main rationales for the use of PPP in NI, focusing on claims of PPP's ability to: provide additional resources, address macro-economic imbalances; and deliver higher efficiency.

Section 1: The use of PPP in NI - current scale and plans for expansion

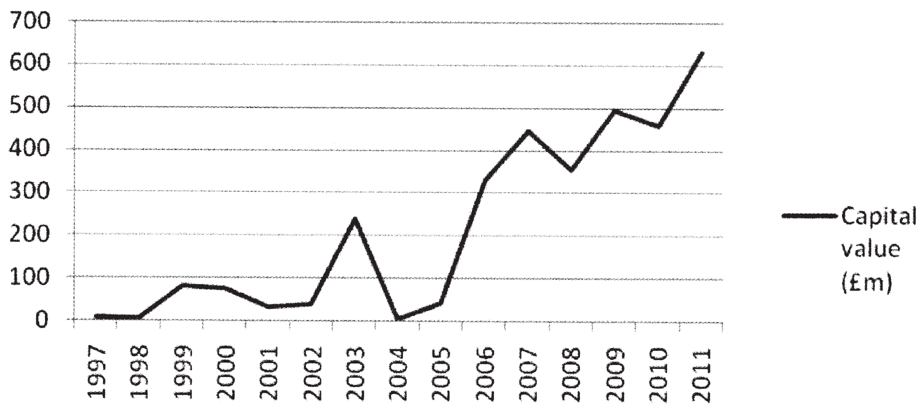
This section examines the scale of privately financed investment committed as of March 2008, and projections of additional investment up to 2012. It also outlines the long-term cost to the public sector of the contracts signed to date, and provide an estimate of the long term cost of projects that are currently being negotiated. It is demonstrated that capital investment through PPP is set to increase significantly over the coming years, a trend mirrored by increases in the public liabilities.

1.1 Capital investment through PPPs signed and in procurement

As of March 2008, there were 35 signed PPP contracts in NI, with a combined capital value[1] of £1.29 billion. This represents capital expenditure of £758 per head of the NI population – a significant figure, though still about £250 less than the equivalent calculation for the UK a whole (ONS 2008). This reflects the fact that private finance was used to a much lesser extent in NI than in the rest of the UK until recent years. Figure 2 illustrates this, plotting the stark increase in the capital value of projects signed per calendar year, from just £8 million in 1997 to £444 million in 2007.

Figure 2 also shows that the capital value of signed PPPs will increase significantly between 2008 and 2011, as the 13 contracts for the schemes now being negotiated are signed. The value of contracts is projected to increase from £353.6 million in 2008 to £630 million in 2011. This will increase the value of PPP contracts from £1.29 billion as of March 2008, to £3.22 billion by the start of 2012, and take the amount of private finance per head of population to £1,138 – higher than the current UK level.

Figure 2. Actual value of projects signed between 1997-07 and estimated value of schemes projected to sign between 2008-11



Source: OFMDFM (2008)

[1] 'Capital value' is an estimate of the amount of capital investment represented by a given PPP contract.

1.2 Government departments involved in PPP

The PPP model has been used across a wide range of NI public services, providing new government accommodation, roads, water infrastructure, waste facilities, hospitals, schools, colleges and libraries. The table below illustrates the sectoral breakdown of PPP investment committed up to March 2008, and projections for schemes now in procurement. On existing schemes, three NI Executive departments - Regional Development (responsible for water and roads); Education; and Health, - have been the main commissioning authorities, accounting for over 90% of the capital value of contracts signed (the largest of which are highlighted in Box 1). Going forward, however, PPP in water and roads is diminishing (along with the environment, social development and enterprise sectors), while it continues to have a major role in education, health and finance and personnel.

NI Executive department	Actual value of schemes signed (£m)	Projected value of schemes in procurement (£m)
1. Social development	26.5	0
2. Regional development	586.2	0
3. Environment	25	0
4. Health	167.05	1,087
5. Finance and Personnel	47	450
6. Enterprise, Trade and Investment	25	0
7. Education	344.6	309.6
8. Employment and Learning	62	88
9. Culture, Arts and Leisure	13.9	0
Total	**1297.25**	**1,935**

Source: OFMDFM (2008)

Box 1 Signed PPP schemes worth more than £50 million in capital value

Regional Development

- a £118 million **roads package**, signed in February 2006. Total unitary charges to be paid on this scheme are £508.29 million between 2006/07 and 2035/36.
- a further roads package with a capital value of £224 million, signed in December 2007. Total charges to be paid on this scheme are £1004.59 million between 2010/11 and 2037/38.
- the £110 million Alpha **water scheme** for the NI Water Service, signed in May 2005. Total charges to be paid on this scheme are £506.86 million between 2008/09 – 2031/32.
- the £122 million Omega water scheme for the NI Water Service, signed in March 2007. Total charges to be paid on this scheme are £640.14 million between 2007/08 – 31/32.

Healthcare

- a £98 million **managed equipment** PPP for the Belfast Health & Social Care Trust, which signed in May 2007. Total charges to on this are £132.93 million between 2006/07 and 2021/22.

Education

- the £104 million Classroom 2000 scheme for **post-primary and special schools**, signed in March 2003. Total unitary charges to be paid are £116.11 million between 2002/03 to 2010/11.
- the £58.2 million Classroom 2000 network scheme, also signed in March 2003. Total unitary charges are £120.16 million between 2003/04 to 2011/12.

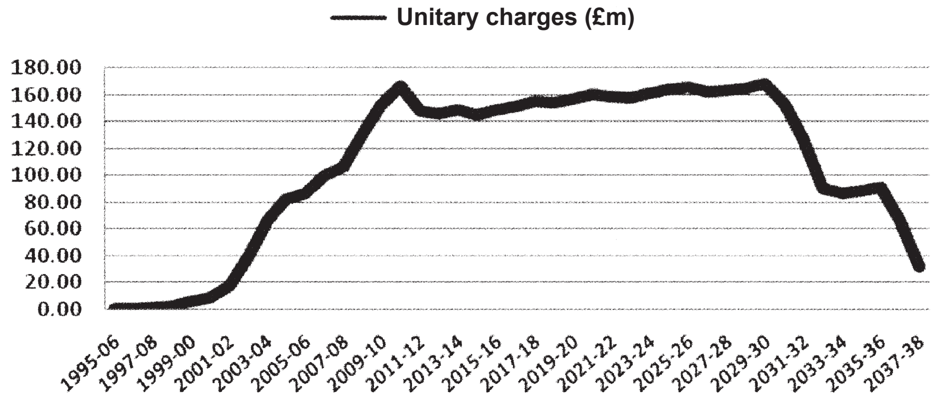
Source: www.hm-treasury.gov.uk

1.3 The impact of PPP on NI revenue budgets

1.3.1 Actual commitments on signed schemes

As explained in the introduction, the capital investment committed by the private sector has to be repaid with interest, along with payments for services. These *unitary charges* are paid by the NI Executive to the private sector over the 25-30 year length of PPP contracts. As noted, capital investment through PPP now equals £1.29 billion. Figure 3 (below) plots the profile of the £4.7 billion of unitary charges (in nominal terms) that accrue to the 35 contracts signed by March 2008. These payments rise from £1.5 million in 1997-08 to reach a peak of £167 million in 2010-11.

Figure 3. Total unitary charges to be paid on schemes signed as of March 2008



Source: www.hm-treasury.gov.uk

1.3.2 Estimated future payments for schemes in negotiation

Clearly, the scale of payments will increase as more projects are signed. However, it is impossible to estimate with any certainty what the public sector costs will be when the schemes currently in procurement are completed. One crude method is to examine the ratio of capital values to long-term unitary charges on schemes that are signed. As noted, the value of schemes signed as of March 2008 is £1.29 billion, and public sector liabilities on these schemes are £4.69 billion in nominal terms, giving a ratio of 3.64. Adding the projected value of schemes currently in procurement produces a total capital value of £3.22 billion - and multiplying this by 3.64 yields the figure £11.73bn.

Given the numerous sources of measurement bias[2], this figure is not very meaningful. Perhaps all we can currently say is that, by 2012, the total cost of PPPs in NI will be in the range of £10-15 billion.

1.4 Plans for PPP from 2012 onwards

The Investment Strategy for Northern Ireland 2008-2018 (OFMDFM 2008) identifies some £20 billion of new investment in the 10 years from 2008 but provides no information on what role PPP will play in delivering this. Indeed, the terms 'public private partnership' and 'PPP' do not appear in the document. It is unclear whether this omission is the result of political management – that is, a desire to obfuscate the true scale of PPP plans, or whether the current Executive is genuinely unsure what the future holds for private finance in NI. What is clear is that there are a number of projects which, by virtue of their large capital investment requirements and long-term nature, are on current guidance (HM Treasury 2003) likely to proceed as PPPs. These include:

- A rapid transit system for the Greater Belfast area. The ISNI states: "The potential to lever in private sector funding will be an important ingredient"
- Significant investment in NI's motorway/dual-carriageway network (part of the Trans-European Network) and upgrades to selected link corridors and trunk roads
- A new Belfast Central Library open by 2015
- Delivery of up to 10,000 new social homes
- Significant increased investment in waste and waste management facilities, in a bid to meet EU targets on water quality and landfill.

[2] For example, past experience shows that both capital and contract costs on PPPs increase during the procurement process, so it cannot be assumed that the currency quoted costs are accurate.

Section 2: Shifting rationales - a decade of PPP policy development in NI

Prior to the first modern period of devolution (1999-2002), PPP had made barely any impression in NI, despite its growing significance in the rest of the UK. The capital value of PPP schemes signed in NI between 1992/93 and 1999/2000 was less than £100 million, compared to £4 billion in Great Britain (HM Treasury 2008). However, in the early days of devolution, NI political parties began to regard PPPs as a potentially important means of increasing investment in public infrastructure.

2.1 The embrace of PPP - first period of devolution (1999-2002)

In July 2001, the NI Assembly's Committee for Finance and Personnel published a report on PPPs, arguing that private finance could provide additional resources to the amount funded by Treasury through the block grant. It stated that, "while the preferred source of finance is public finance because it can be provided at lower interest rates than private finance and ensures that responsibility for provision of public services remains within the public sector", PPPs would have to play some role in infrastructure delivery since "the Treasury is unlikely to meet all of the outstanding financial needs of NI from increased public expenditure in the short to medium term" (CFP 2001, p.5).

Using PPP to deliver additional finance was subsequently advocated by Mark Durkan, the NI finance minister in the first devolved administration. He told the Assembly that: "we do not wish to use public private partnership as some form of privatisation. The aim is to ensure that we maximise our public investment...in our circumstance the rules are clear: if we borrow, the full amount is deducted from our public expenditure block - we do not get the additional expenditure."[3] He added that ruling out PPP would be "doctrinaire" as it would "limit our opportunities to provide services of a modern standard in the sort of facilities that people have every right to expect" (NIA, 2001).

To understand this argument, it is necessary to briefly outline the capital finance system in NI. Most public expenditure in NI is funded under the *Assigned Budget*,[4] which is set by Westminster, under the Barnett Formula. This adjusts funding to reflect changes in per capita expenditure in England. The Assigned Budget provides funds for spending on services such as transport, health and education (i.e. those that are administered by the Northern Ireland Executive in devolution, and the Northern Ireland Office during direct rule). It is composed of a *capital budget* (money for investment in buildings and equipment) and a *revenue budget* (money for the provision of services).

Under this system, capital spending funded through the use of NI resources or through direct borrowing is tightly constrained. The capital used will count against NI's (very limited) capital budget, reducing the scope for alternative expenditure. In addition, there

[3] Under the Reinvestment and Reform initiative, agreed with HM Treasur in 2002, an (initially limited) power to borrow was provided, so long as this was paid for out of locally-raised taxation (Heald 2003).
[4] This is the block grant from HM Treasury and accounts for more than90% of total expenditure in NI.

are ongoing capital charges on the investment that will, along with depreciation, count against the NI revenue budget. [5]

In contrast, under current Treasury rules, so long as a PPP is *off-balance sheet* (i.e. the project is recorded as a contract for services rather than a financial lease in the public sector's accounts), there will be no direct impact on the NI capital budget, while annual charges count against the revenue budget as they are incurred. The effect of this is that, while capital spending faces two constraints, on both capital *and* revenue budgets, projects financed through PPP face only the latter. This is the source of the claim that private finance can deliver "additional" public sector investment.

In line with CFP recommendations, an inter-departmental working group was established and a report issued for consultation in May 2002. Reflecting the themes of the CFP's work, the report advocated limited use of PPPs for the purpose of increasing investment, with a social partnership approach involving trade unions and the voluntary sector in project decisions (OFMDFM, 2002).

2.2 Putting the PPP structures in place - direct rule (2002-2007)

In October 2002, responsibility for the development of investment policy in NI passed to Westminster with the re-imposition of direct rule in, which was to last until May 2007. Perhaps the first substantive act of direct rule ministers in NI was to launch a Strategic Investment Programme, as part of the Budget announcement in December 2002. This set out plans for around £2 billion of investment over the five-year period to 2007-08, including £725 million through PPP and £400 million of direct borrowing, with the remainder funded through the block budget.

It was under direct rule that ministers finalised the policy framework for the use of PPP in NI, and the bureaucratic infrastructure was established to deliver it. This framework was outlined in the document, *Working Together in Financing our Future* (OFMDFM and DFP 2003) which stated that there would be a "strong preference" for PPP in infrastructure and accommodation projects. This was in contrast to the "limited" role for PPP that had been envisaged in the working group report, suggesting that the role of private finance would be expanded still further under direct rule.

This "strong preference" was reflected in the staffing of the new Strategic Investment Board (SIB), the expert procurement body originally advocated by the CFP and supported in the working group report. The SIB was established as an independent government agency, but was staffed by individuals from the PPP industry, and headed by Andy Carty, a director of Partnerships UK (PUK), the half-public, half private body that is both the UK government's expert body on PPP and the policy's main advocate. The choice of Carty (and his successor David Gavaghan, from David Wylde Project Finance) reflected the centrality of PPP to the investment plans of direct rule ministers.

Long-term plans for investment in NI were published by the SIB In December 2004, in a draft investment Strategy for NI, setting out a potential £16 billion programme of infrastructure investment for the ten years to 2015, with the priority on schools, hospitals,

[5] Public entities must pay the Treasury for the use of their buildings through annual capital charges.

housing and water infrastructure. The finalised “Investment Strategy for Northern Ireland 2005-2015” was published in December 2005, and specified that 23% of the programme – the part of it dealing with large-scale infrastructure and accommodation projects - would come through PPP.

In *Working Together*, direct rule ministers maintained the rhetoric of “social partnership” that was a core theme in the CFP and working group reports. However, the new “strong preference” for PPP, and the key role now being played by practitioners and advocates of PPP within the SIB, rendered meaningless this commitment.

2.2.1 A new policy rationale during direct rule

While the alleged ability of private finance to deliver “additional” resources was, as shown above, the central motive behind PPP’s expansion during devolution, the rationale was broadened under direct rule. *Working Together* had signalled this change in emphasis, stressing the ability of PPP providers to introduce “reform and change management” in the public sector so as to develop “new working practices or less bureaucratic procedures” (p. 3). Combined with the “strong preference” for private finance, this set the stage for the major expansion of PPP outlined in Section 1 of this report.

The importance of this new rationale grew during the period of direct rule, and mirrored reforms in England where the private sector was encouraged to play a larger role in the public services delivery. However, this agenda had a distinct role in NI where PPP was regarded as playing a role in a wider attempt to “rebalance” the NI economy in favour of the private sector. Direct rule ministers argued that the NI public sector was too large; that the level of a public expenditure per head was higher than the UK as a whole and that it needed to be reduced; and that efforts had to be made to stimulate the private sector, including through the use of tax-funded services (Hain 2006).

The *Review of Private Services in NI* (NIERC and Regional Forecasts 2004), commissioned by the Northern Ireland Office, suggested that the “Direct Rule Administration promote privatisation of appropriate organisations still in the public sector” (p.9). Privatisation should include “whole organisations” but also “individual government activities could be hived off to the private sector to a greater extent than at present” (p.115). In response to this, the NIO said it would “look at areas where public/private partnerships in capital projects can help lever in private finance to Government projects” and “continue to explore how the private sector can be most effectively engaged” (p.6).

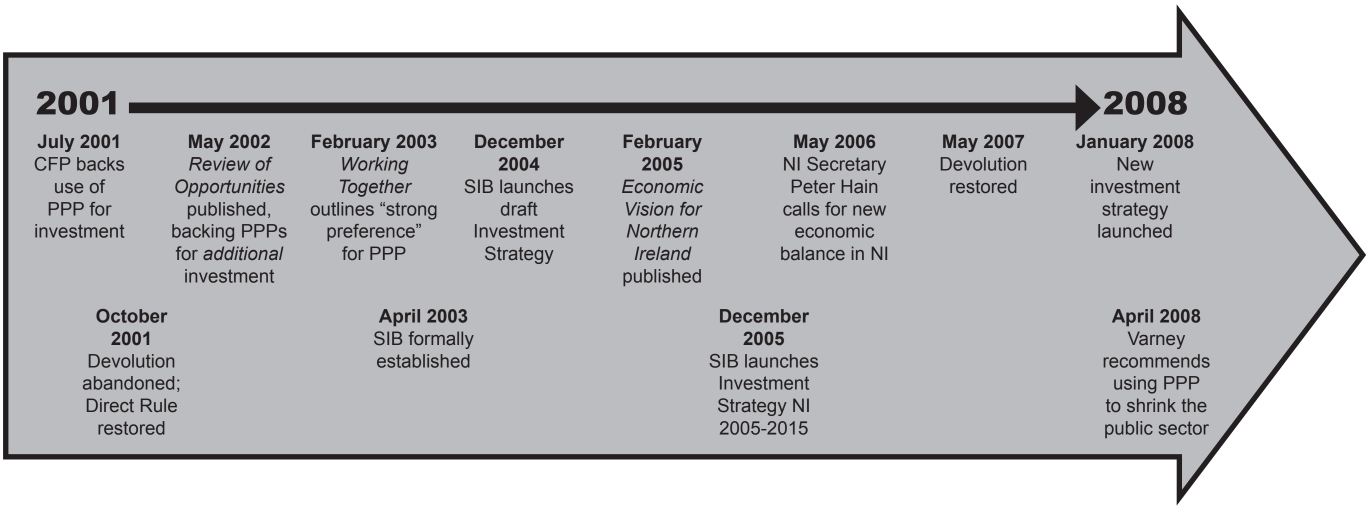
Similarly, the *Economic Vision for NI* (DETI 2005) said the government would deliver “a reformed public sector which is in better proportion to the size of the private sector” and “exploit greater partnership between the public and private sectors for the delivery of services and facilities” (p.9). This stood in contrast with the stated preference of the Committee of Finance and Personnel’s for retaining services within the public sector; and the statements of devolved ministers that PPPs were about increasing public investment, and were not intended to result in any privatisation.

2.3 Devolution restored

With devolution restored, there is evidence that the NI Executive is moving away from this macro-economic agenda. The Executive's 2008-11 NI Budget, for example, contested the claim that the Province's public sector is too large and needed to be reduced. However, under current constitutional arrangements, Whitehall maintains strong levers with which to influence policy in NI. For example, the Treasury continues to apply pressure on the Executive to reduce the size of the public sector, and has identified the use of PPP was one important means of doing so.

The Treasury-commissioned 'Varney II' report (2008), for example, states: "One way to increase the value for money of the public sector, and to help stimulate the private sector, is to increase the role of the private sector or third sector in delivering public services" (P.109). Information on the future role of PPP in NI is hard to access due to the lack of detail in the latest Northern Ireland Investment Strategy. However, there is no evidence at the moment that the NI Executive is reviewing the use of PPP.

Figure 4 A chronology of PPP policy development in NI



Section 3: Evaluation of the arguments for PPP

This section examines the two central drivers behind the use of PPP in NI, outlined in section 2: namely, the claim that private finance can deliver extra resources for public investment; and that it can enhance the macro-economic value of NI. The argument is presented that these rationales are without merit: the only credible rationale for the use of PPP is that it is capable of delivering projects and services with greater efficiency, or "value for money", than the alternatives. The final part of this section provides a review of the evaluative literature on the issue of value for money.

3.1 Does private finance provide 'additional' resources for public services?

3.1.1 Capital and revenue resources in NI

As noted in section 2, under the current NI funding regime, capital spending financed through the direct use of resources or conventional borrowing is tightly constrained. The capital used will count against the already limited NI capital budget, thereby reducing the scope for other projects, and capital charges and depreciation count against the NI revenue budget.[6] In contrast, the upfront costs of *off-balance sheet* PPPs have no impact on the capital budget, and only the annual charges appear on the public sector's accounts. This means that, while conventional capital spending is constrained by capital *and* revenue budgets, only the latter impacts on most projects financed through PPP.

This provides NI administrations – whether devolved or Westminster-based - with an incentive to use PPP, as it appears to provide scope for investment that is additional to what could be provided through conventional capital spending or borrowing.[7] Because capital budgets are so low in NI, and the power to borrow is tightly constrained, this incentive operates *even where the revenue impact of private finance is greater* than alternative methods. Section 2 of this report shows that the NI Executive was – quite openly - responding to this incentive when it chose to expand its use of PPP, with both the CFP and the finance minister emphasising PPP's 'additionality'. NI Office ministers also faced these constraints during direct rule, and therefore operated under the same incentive.

As the International Monetary Fund (2004) notes, the "off-balance sheet" status of PPPs introduces an "unwarranted bias in their favour", providing a "superficial" relaxation of budget constraints. The relaxation is "superficial" because investment through PPP has exactly the same revenue effect as conventional capital spending or direct borrowing. This public sector costs that PPP gives rise to can only be met through a redirection of revenue from other parts of the public sector, increased taxation or, for sectors like roads and water, higher user charges. The budgetary advantage of PPP – that while direct borrowing counts against the capital budget, borrowing through a PPP intermediary does not - is the consequence of financial reporting structures developed by the Treasury, and does not reflect any economic difference between alternative forms of financing (Heald 1997).

[6] Public entities must pay the Treasury for the use of their buildings through annual capital charges.
[7] Because England uses PPP to finance most of its large-scale capital investment, the capital budget for NI may be set lower than it would otherwise be under the Barnett formula for territorial revenue allocation. The incentive to use PPP is particularly strong for devolved governments in the UK, since not using private finance implies a lower level of capital expenditure than England, which may have political consequences.

If PPP cannot provide additional resources to devolved administrations, why might the Treasury wish to give ministers a budgetary incentive to use it? The reason is that the Treasury faces a very similar political incentive to the one outlined above, largely because of self-imposed fiscal constraints.

Across Europe, finance ministries are interested in PPP because of its ability to deliver investment, the upfront costs of which do not count against measures of public sector debt. All EU member states are subject to fiscal constraints under the Maastricht Treaty, which restricts 'gross government debt' to 60% of national Gross Domestic Product (GDP). In the UK, the fiscal rules are less flexible. Since 1998, the Labour government's 'sustainable investment rule' has imposed a ceiling of 40% on the ratio of 'public sector net debt' (PSND) to GDP, which is consistent with a much lower debt-to-GDP ratio than that specified in the EU Stability and Growth Pact.[8]

As long as privately financed investment is recorded off the public sector's balance sheet, then it does not count towards the PSND.[9] And, as the sustainable investment rule is an important benchmark of the Treasury's economic prudence, it has an incentive to encourage the use of private rather than public finance for new investment, even where the present value cost will be higher.

3.1.2 Changing accounting practices

The NI Executive's ability to keep private finance off balance sheet has been reduced over recent years.[10] This ability will be reduced even further when the UK government moves to International Financial Reporting Standards (IFRS) from 2009/10. Under this system, it is likely that PPPs will be accounted for in accordance with IFRIC 12, an Interpretation of IFRS issued by the International Accounting Standards Board and strongly supported by the Financial Reporting Advisory Board (FRAB), to which the Treasury is accountable. This declares that private operators should not record the up-front capital cost of PPP projects on their balance sheets if overall control of the asset concerned is not in their hands – and this is the case for the vast majority of PPP projects.

Under pressure from FRAB, the Treasury has accepted that a "mirror-image treatment" of IFRIC 12 is appropriate for the public sector (Heald 2008). This means that investments under PPP will have to be recorded on the balance sheet of the public sector, thereby scoring against the budgets of departments and devolved administrations. It is also likely that, from 2009/10, many PPPs will also score against PSND and, unless it is reformulated, the sustainable investment rule (ONS 2007).

From a financial transparency point of view, the move to IFRS will be widely welcomed if it removes perverse incentives to use PPP. On the other hand, with the accounting-driven advantage of PPP eroded, it is essential that ministers consider how investment by devolved administrations is to be funded if shortfalls in capital investment to be avoided. It remains to be seen whether the Treasury will introduce new regulations that will allow the NI Executive to meet its investment needs.

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[8] It is likely that this ratio will be changed in the forthcoming Autumn Pre-Budget report, due to new economic circumstances and rising public debt. Whatever ceiling is imposed, the Treasury will retain an incentive to circumvent it if it can achieve politically desirable results – e.g. higher levels of investment – by doing so.

[9] For example, the Treasury's seminal statement on its policy towards PFI states that private finance "can relieve the pressure on public finances" (HM Treasury 2000; p.13).

[10] Some 60% of the finance committed to so far on signed PPPs in NI is off-balance sheet (HM Treasury 2008)

3.2 PPP as a means of rebalancing the economy

As discussed in Section 2, during direct rule PPP was advocated as one way of rebalancing NI's economy in favour of the private sector, and the Treasury has continued to lobby for this policy to be pursued during the current period of devolution (e.g. Varney 2008).

This "macro-economic" rationale for the use of PPP is problematic for three reasons:

(1) The argument that the public sector is too large in NI is an oversimplification. It is the case that NI has a higher level of public expenditure per head than in GB (Mclean et al 2008). However, an important part of this is connected with social security payments. These are much higher than in GB, not least because the number of benefit claimants is 50% higher than on the mainland. Relatedly, certain government reforms, for instance on tax credits, have inflated the 'subvention' to NI (Gudgin and Gibson, 2008). The public expenditure differential between the NI and GB is therefore largely a function of transfer payments and does not imply higher spending on public services.

In terms of employment share, NI has a higher percentage of individuals in the public sector than the rest of the UK - estimated at 28% in NI, compared to 20% (NI Executive 2008). However, when the size of the public sector is measured in terms of public employment as a proportion of population, NI is similar to other parts of the UK. What this suggests is that the private sector after decades of under-investment during The Troubles is too small, not that the public sector is too large. In this context, a crude attempt to reduce the size of the public sector could have serious consequences for the economy (Gudgin and Gibson, 2008).

(2) A significant implication of procuring through PPPs, rather than conventional procurement, is the freezing out of local companies in favour of large multinational corporations, which can better handle the transaction costs involved. The average bidding period for PPP schemes is around three years, requiring significant legal, financial, and technical advisory costs for both sectors (National Audit Office 2007). Because of this, authorities tend to 'batch' individual construction schemes into larger units in order to create economies of scale,[11] with the result is that most projects are in the range of £50-£250 million range in terms of capital value. Together, these factors are known to deter small and medium enterprises (SMEs) from bidding for PPPs (Ezulike et al 1997).

This is likely to have a negative impact on economic growth in NI, a region that has a relatively small number of large, high-turnover companies and an important SME sector. According to Varney (2008), the Province has only 45 businesses with more than 500 employees, compared to 4,510 in the UK as a whole - a difference of a hundredfold, even though the UK population is only around 34 times higher than that of NI. Even if the few large NI firms were able to find the resources to bid for this work, it is unlikely they would be competitive. Established PPP firms from the UK, Europe and the US have absolute cost advantages over potential local bidders, since bank finance rates will be unfavourable for consortia with limited experience of PPP (Standard and Poors 2004).

[11] Indeed, Treasury guidance issued in 2003 expressly forbids PPPs under £20 million in capital value.

To this extent, the prioritisation of PPP over other forms of public procurement actually runs counter to the project of stimulating growth in the domestic private sector. It also runs counter to one of the recommendations of the Varney review to the NI Executive: to ensure that "government procurement can play an important role in driving SME innovation and growth" (p.109).

(3) The suggestion that shifting a service from the public to the private sector could, in and of itself, add value to an economy is a misconception. Moving a given service from the public to the private sector has no impact on GDP, nor on the underlying worth of the economy. Services transferred to the private sector through PPP will still be tax-funded. All other things being equal, PPP does not imply any reduction in public spending, or any relaxation of the public sector's budget constraint.

An argument has been made that public servants are too highly paid in NI's public sector, and this is "crowding out" the private sector, where wages are some 20% lower. This argument is strongly contested by public sector trade unions. In any case, under TUPE and related UK government regulations, staff transfers through PPPs cannot result in lower wages or pensions, so PPP is irrelevant to this issue. In any case, Heald (2003) suggests that the public sector in NI now competes for manpower and skills with the Republic of Ireland, where public sector employment has grown rapidly in recent years. Any attempt to radically reduce wages in the North is likely to lead to net out-migration of mobile, well-qualified staff (Gudgin and Gibson 2008).

3.3 PPP and value for money

Perhaps in recognition of the weakness of the arguments for PPP that are outlined and critiqued above, the policy is also justified on cost-efficiency grounds. At first blush, the value for money case for PPP appears weak since public finance is cheaper than private finance. This is because lending to government is extremely low risk - public bodies, unlike private companies, are unlikely to go bankrupt and default on their payments. The transaction costs of government financing are also low and the market in government debt is usually liquid and efficient (Yescombe 2007).

3.3.1 Financing costs in PPP

In its examination of financing costs for Scottish schools PPPs, Audit Scotland (2002), found overall rates of return on private finance in the range of 8-10% a year, some 2.5% to 4% higher than a public authority would pay if it had borrowed money on its own account. Similarly, in a study of the first 12 PPP hospital projects in England, Shaoul et al (2008) found private finance costs of about 8% - well in excess of the 4.5% available on public finance in the relevant period. Financing costs matter in a PPP, just as they do in projects funded through direct borrowing, as they are part of a project's costs and to a large extent determine the level of the annual payments that the public authority must fund.
The Freedom of Information Act has enabled independent scrutiny of PPP 'financial models', documents which contain estimates of a project's profitability. Cuthbert and Cuthbert (2008) looked at the cost of two completed hospital schemes in Scotland, the Edinburgh Royal Infirmary and Hairmyres, and compared this with an estimate of what these projects would have cost had public finance been used. To do this, they compared for each scheme the net present value (NPV)[12] of returns to investors with the amount of private capital raised to finance the construction work.

[12] Based on a discount rate of 5% - the National Loan Board rate at the time these projects reached financial close.

On the Edinburgh Royal Infirmary scheme, they found the cash value of the returns on private capital (excluding payments for operations, maintenance and service provision) was £760 million. This was then discounted at 5% - the rate of interest that would have been paid by these hospitals on public finance at the time their contracts were signed – to give the figure £416 million, more than twice (2.04) the £181 million of capital raised by the private sector to build the hospital. The same analysis was applied to the £68 million Hairmyres scheme, generating a similar ratio (1.97). Although they are estimates, these ratios provide an indicator of the cost of these facilities to the NHS, relative to what the cost would have been, had the required finance been accessed through direct borrowing. The authors concluded that PPP is a "one hospital for the price of two policy" (p.5).

The Treasury argues that the higher cost of private finance is simply a function of the risk of investment being explicitly priced (HM Treasury 2003). On this analysis, when government finance is used for a project, the risks associated with the investment are the same as in a PPP, but any additional costs (e.g. due to time and cost overruns in construction, or problems in operation) are passed on to current and future taxpayers. In contrast, in a PPP, these project risks are borne by private investors, rather than taxpayers, and are priced according to standard methodologies.

The claim that the cost of private finance is simply the cost of public finance, plus a "risk premium", is therefore fundamental to the micro-economic case for PPP. If the cost of private finance is the same as public finance after allowing for risk, and the private sector is able to manage this risk and deliver projects more cheaply, then the total cost of a PPP could be lower than a public project.

However, the available evidence suggests that this is not the case. Research commissioned by the Office of Government Commerce (OGC), and carried out by the accounting and management consultancy PricewaterhouseCoopers (2002), shows that private finance costs are significantly higher than is predicted by the Treasury's claim. PwC analysed 64 PPPs that were signed between 1995 and 2001, comparing for each project the projected rate of return on capital with a benchmark designed to reflect the return that *should* be expected on the scheme, given its costs and risks.

The study found that projected rates of return exceeded the benchmarks by an average of 2.4%.[13] While this may appear to be a narrow margin, it represents a substantial amount of money over the life of a contract of 25 to 30 years or more. What PwC calls "excess returns" of as little as 1% could lead to an increase in overall costs to the public sector of 10% over the term of a 30 year contract.

The credit crunch is increasing the cost of private capital relative to public funding (Hellowell 2008). Investors in public projects have been hit by the shortfall in bank liquidity in much the same way as homebuyers and businesses, with finance now being rationed and credit margins increasing. The impact of this is two-fold. First, bond finance, hitherto much the cheapest form of senior debt finance for PPPs, is no longer available. This is because the US 'monoline' insurers, such as Ambac and MBIA, lost their triple-A credit rating in the wake of the US sub-prime crisis. These institutions played a key role in the

[13] According to the National Audit Office (2007), the level of competition is low in the PPP market, and declining. Between 2004 and 2006, only 67% of PPP projects received three or more bidders. One third of projects attracted only two bidders at the point at which detailed bids were submitted.

commercial bond market, guaranteeing repayments to bondholders in return for a fee, reducing overall financing costs, in particular for many larger PPP projects.

Second, in the bank finance market, now the only source of senior debt for PPP investors, liquidity has reduced dramatically since July 2007 and, where credit is available, the cost is very high. This is partly because the banks' own cost of capital has increased due to the fact that banks are no longer willing to provide credit except at high interest rates. In addition, the shortfall in liquidity has reduced competition in the senior debt market. Rather than lending individually, banks are now lending as cartels, or "clubs", and as a consequence of this, credit margins (the interest rates above the banks' own costs) have doubled in the last year. Pre-credit crunch, credit margins on simple accommodation schemes like schools and hospitals were between 60-80 basis points (0.6-0.8%) above the bank's own cost of capital. This has now increased to 100-150 basis points (PricewaterhouseCoopers 2008).

It is significant that the UK government's own evidence base suggests there are "excess returns" to investors. This is a particular cause for concern given that private finance costs are now increasing to historically high levels. This implies that, to be value for money, the private sector must be so much more efficient than the public sector that it can *more than offset* its higher cost of finance through being more able and better incentivised to manage risk. In principle, it is possible that this is the case, but there is clearly a high burden of proof given the evidence of excessive profitability. As we see below, no valid evidence has been provided by the government is support of its assertions.

3.3.2 The evidence: the public sector comparator

Under Treasury rules, public authorities must subject their private finance plans to a value-testing exercise, part of which is based on a *public sector comparator* (PSC) – an estimate of what the project would cost under public finance. In theory, where a PSC concludes that private finance does not represent value for money, a public procurement method should be chosen. In practice, PPP almost always comes through the PSC exercise as the more efficient option, and this has been presented by the Treasury as good evidence that the model is cost-efficient (HM Treasury 2000).

Since the logic of PPP is that it leads to greater cost efficiency through the private sector managing more effectively project risk, the principle is that risk should be added to the PSC to make this comparable with the cost of PPP. However, this process has been fundamentally discredited by academics and auditors (Gaffney et al 1999; Price and Green 2000; NAO 1999), who point out that the accounting-driven advantages of PPP strip these appraisals of any objectivity.

For example, Gaffney et al (1999) note "a tendency" for public authorities engaged in the PSC process to ascribe risks to PPP consortia that they will never in fact be asked to bear, and thereby artificially inflate the cost of the PSC relative to the PPP. For example, on one hospital project, one of the risks supposedly transferred to the private sector was that targets for clinical cost savings would not be met. The cost of this risk was estimated at £5 million and added to the PSC figure. However, the consortium had no responsibility for ensuring such savings would be made, and faced no penalty if they weren't. The authors conclude that the PSC process was "often spurious".

Jeremy Colman, former deputy general of the National Audit Office, the supreme public sector audit institution in the UK outlined a similar conclusion in comments made to the *Financial Times* (since confirmed by Colman in a personal communication with one of the authors). Mr Colman noted that many appraisals were guilty of "spurious precision", based on "pseudo-scientific mumbo-jumbo". He noted the perverse incentive facing authorities to manipulate appraisals, in a context in which private finance is usually the only funding source available: "If the answer comes out wrong you don't get your project. So the answer doesn't come out wrong very often" (Timmins 2002).

3.3.3 The evidence: time and cost overruns

More recent government attempts to justify the dominance of PPP in large-scale capital investment have focused on the model's ability to deliver projects "on time and to budget". For example, the Treasury (2003) states: "[our] research into completed [PPP] projects showed 88% coming in on time or early, and with no cost overruns on construction borne by the public sector. Previous research has shown that 70% of non-PFI projects were delivered late and 73% ran over budget" (p.43).

After repeated Freedom of Information requests for the Treasury's work on cost and time overruns, officials confirmed that no research report exists. Accordingly, the 88% figure quoted above cannot be validated. Meanwhile, the "previous research" noted refers to two reports from the National Audit Office, Mo*dernizing Construction and PFI Construction Performance.* But neither of these studies compares relative performance under different procurement routes. The first is based on interviews with industry about the scope for improved construction. The second is a census of 38 project managers. Indeed, the latter report states: "it is not possible to judge whether these projects could have achieved these results using a different procurement route" (NAO 2003).

In any case, comparing PPP and non-PPP projects for post-contractual price increases (what the Treasury appears to mean by "time and cost overruns") is not a valid method for testing overall value for money. Under a PPP, the risk of cost and time overruns is transferred to the private sector, so it has little flexibility to increase its price during capital works unless major problems emerge. Instead, under PPP, the private sector increases its price *before* contracts are signed. It is assisted in doing so by the *preferred bidder* stage - a post-competitive phase of PPP procurement in which the public authority enters into a long and exclusive negotiation process with a single consortium.[14]

During this period, the private sector can 'hold-up' the public authority, using its advantageous bargaining position to increase prices and reduce the extent of risk transfer. Meanwhile, the scope for public authorities pulling out of such negotiations is limited by the non-availability of other financing routes. In proposing that post-contractual price certainty can be taken as an arbiter of overall efficiency, the Treasury is setting up a comparison which is bound to favour the PPP method. A project that is delivered to time and to budget (in post-contractual terms) may represent very poor value for money if the price paid for the risk transfer that led to that outcome was too high.

[14] According to the National Audit Office (2007), the average length of preferred bidder negotiations for projects that signed between 2004 and 2006 was 15 months.

Conclusion

The reasons for the adoption and expansion of PPP under devolution stem from an accounting regime that does not reflect the underlying economic reality. Using PPP allows the scoring of investment to be postponed against the Assigned Budget, creating an incentive to pursue this model even when the long run cost to taxpayers will be higher. It is clear that the NI Executive and the NI Office were responding to this when formulating capital expenditure policy in the late 1990s.

Under direct rule, PPP was seen as a way of "rebalancing" the economy through transferring services from the public to the private sector, shrinking the former and expanding the latter. However, the argument that the public sector is "crowding out" the private sector is poorly evidenced, and the fundamental characteristics of PPP are actually likely to *reduce* the capacity of government action to stimulate expansion in the private sector. The notion that any value is added to the economy simply through transferring services from public to private is a misconception: the only way such a transfer can be beneficial if it brings about improvements in productive efficiency, or "value for money".

The final section of this report looks at the evidence on PPP's economic credentials. While PPP in NI is due to be radically expanded between now and 2012, there is no credible evidence base that supports this policy. It would appear that the capacity for any improvements in efficiency is eroded due to the excessive profitability of contracts for investors. The evidence shows that rates of return are well in excess of market norms, suggesting the price being paid for risk transfer is too high.

At the current time, the cost of private relative to public funding is rising significantly due to the current financial crisis. This has eliminated the bond finance market –previously the cheapest source of private finance - and curtailed the availability of bank finance. In turn, this has further reduced the degree of competition in the market for finance, and allowed banks to *double* their credit margins.

The change from British to international accounting standards will remove the NI Executive's reason for using PPP – its superficial 'additionality' advantage. At the same time, the economic slowdown means that NI will receive lower increases in funding from the Treasury than has been the case in the last decade. In this context, the high (and increasing) costs of PPP are likely to put pressure on the NI Executive to increase regional taxation and user charges in areas such as water.

We suggest that the time is right for an independent review of capital investment policy in NI, and we recommend a moratorium on the further use of PPP until this is completed.

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Published by:
Northern Ireland Public Service Alliance
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Tel: 028 9066 1831 **Fax:** 028 9066 5847 **Minicom:** 028 9068 7285
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Ref: 12-08