PFI Forum

The Private Finance Initiative (PFI) is the new buzzword as tool to finance construction projects under the Ninth Malaysia Plan (9MP). A sum of RM20 billion has been set aside to get the ball rolling. These articles were extracted from The Edge dated October 2, 2006 for readers information and to keep them abreast of the latest development on PFI.

PFI — cure for all ills?

By Risen Jayaseelan and Maryann Tan

The acronym PFI, which stands for private finance initiative, is all the rage in the construction sector these days. It is also seen as the cure for ills associated with the construction industry and the Government’s reluctance to lavish on big projects due to its own balance sheet constraints. In an environment where the Government is seeking to reduce its budget deficit by curtailing spending on construction projects, PFI is offering construction companies fresh hope for new work.

Indeed, the Government’s reluctance to spend big bucks on construction projects is only to be expected. In the past, most Government jobs have been plagued by delays and shoddy workmanship, which inherently gave it problems and heavy expenditure.

In a nutshell, the archetypical PFI is one which relieves the Government of the burden of funding infrastructure projects and also construction risk. The contractors intending to partake in PFI projects have to raise their own funding for the projects from the market and only get paid when the job is done to the Government’s specifications and performance. This ensures that contractors deliver on what they promise. The Government leases the facilities from the contractors after the latter have built the structures up to expectations. Contractors will also have to maintain the assets and get paid progressively as long as the asset is up to the mark. For instance, if a wall in a school collapses, the lease payment stops until it is rectified. By such checks and balances, it is ensured that the contractors do not do shoddy jobs.

On paper, it is the perfect solution. But are PFIs going to really act as the panacea for the Government?

In all likelihood, Malaysia is coming up with its own version of the PFI, which deviates somewhat from the ideal PFI principle. This is to take into account the business and political reality of the country. This is especially so in the first phase of the PFI, involving about RM20 billion in projects under the Ninth Malaysia Plan (9MP). The amount will be divided among the education (RM9.5 billion), housing (RM1.6 billion), healthcare (RM878 million) and transport (RM634 million) sectors.

Details of the Malaysia PFI structure are just trickling in. For example, a special purpose vehicle called PFI Sdn Bhd will play a central role in implementing the first phase of PFI projects in the country, which involves jobs worth RM20 billion.

PFI Sdn Bhd, a wholly owned subsidiary of the Ministry of Finance (MoF), will play a key role in the implementation of the projects, explains Professor Ismail Salleh. “The details on how they will go about implementing these have not been firmed up yet,” he says. Ismail, along with Datuk Kamal Salih, is adviser to the Government on PFI.

Aside from the RM20 billion, there will also be other PFI projects, which could be initiated by the Government or the private sector. Projects such as the Second Penang Bridge will fall outside the RM20 billion job scope. “The Second Penang Bridge is a good example of a PFI project initiated by the Government, while the bullet train could be one initiated by the private sector,” says Ismail.

Deviation

Projects such as the Second Penang Bridge are likely to be more in tune with the strict PFI structure. But as far as the RM20 billion worth of jobs to be handled by PFI Sdn Bhd are concerned, a key deviation from strict PFI principles is in relation to how the projects will be financed.

To kick-start PFIs in the country, the Employees Provident Fund (EPF) has been called on to provide RM20 billion in funding for PFI Sdn Bhd.
PFI Sdn Bhd, in turn, will use this to finance the selected contractors of the projects. It is understood that preference will be given to small bumiputera contractors, at least in the first phase involving the RM20 billion. It has been reported that under the 9MP, 60% of all capital works still have to be awarded to bumiputera entrepreneurs.

Ismail acknowledges that the RM20 billion worth of projects is targeted at small construction companies, but expects these companies to form consortiums to cover all aspects of their bid. “They are encouraged to form consortiums to submit their bids,” he says.

However, a key question being asked is, why aren’t these contractors being made to secure their own funding for these projects? This is how PFIs worked in the UK. And therein lies the social objective of Malaysia’s version of PFI — that because many of these contractors are small players, they lack the track record to secure financing at a level which would make their project viable. But it also raises the question as to whether these contractors are able to undertake and complete the jobs in the first place.

Undoubtedly, if the projects provided sufficient returns and the contractors had a good track record, raising funding for the projects would not be difficult. One way of overcoming the problem would be to open the floor to big contractors instead of the small players. The big players have the capacity to come up with their own financing and hence, the EPF’s role will become unnecessary. But that will run against the social agenda.

**Selection process**

In any event, the selection process and review of projects under PFI are crucial to help alleviate some of the shortcomings in the previous system. How much the Government eventually pays for these projects is crucial because of what has happened in the past. It is no secret that previously, the Government had entered into lop-sided agreements with the private sector.

For example, how the state could agree to take-or-pay terms in water supply at fixed, step-up rates is beyond comprehension. Why allow an independent power producer to earn returns on equity of over 30% when it carries minimal risk? Yet these concession agreements are shielded from public inquiry by the veil of the Official Secrets Act.

But things could be different now. “PFI Sdn Bhd will use benchmarks of a ‘public sector comparator’ (PSC) to ensure that the Government gets value for money,” explains Ismail. The PSC is a benchmark that has been drawn up based on costing incurred by the Government in carrying out projects such as the building of schools, hospitals and other facilities. Adds Kamal, “PFI Sdn Bhd will invoke the value-for-money test. In short, the cost of capital expenditure and the maintenance of the project through the life of the whole project (until it is transferred to the Government) must be lower than the PSC benchmark.”

While the Government may already have PSCs for the building of schools and hospitals, it may not have the expertise in newer areas, such as bullet trains and bridges. “We will use the best consultants in Malaysia or overseas to come up with the PSCs for such projects,” says Ismail. Adds Kamal, “All projects will be given out on a tender basis and will be benchmarked against the PSCs. The PSCs will remain confidential and the consultants who are helping us develop the PSCs will not be allowed to work for any of the bidding parties.”

It is likely that the Public Works Department will pay a key role in drawing up the PSCs for most of the standard construction projects. “It is also likely that projects which the Government had planned to implement in the past but had pulled back for one reason or another could now be revived through PFI,” says Ismail.

**There should be no restrictions**

While these two Government advisers are confident that PFI will change the way things are done, not all share their view. Some feel that the Government’s version of the PFI, particularly for jobs for the initial RM20 billion where the tendering pool is restricted, may not achieve efficiency.

“Only through a competitive tender and bidding process will the Government achieve efficiency. In the UK, the Government’s review of PFI projects in 2006 revealed that savings in procurement was the biggest positive aspect of the PFI policy,” notes Chew Seng Kok, managing partner of Zaid Ibrahim & Co and frequent commentator on public-private partnership (PPP) and PFI.

Considering the socio-political element of this first phase (meaning the RM20 billion) of PFIs, perhaps what the Government should ensure is that only the best of the small contractors are picked to participate in the projects. Another key element would be funding. The relationship between PFI Sdn Bhd and the contractors is one which is not finalised yet. Here, the Government should ensure that it does not make full payment to the contractors before the projects are delivered to it.

Instead, a scheme should be set up where contractors are only paid based on the milestones reached. This way, it will ensure that the contractors do not take the Government for a ride. Another element which should be put in place is that the profit margins of the contractors should be limited in the construction of the project itself. Rather, margins should be attractive when it comes to the maintenance of the building. This ensures that the
contractor will be in for the long run and one of Malaysia's biggest woes, of badly maintained infrastructure, will be addressed.

Another concern is the EPF's involvement. A key question raised is whether the EPF is going to bear the risk if the contractors fail to deliver. But the EPF has stressed that it would not bear any construction risk. "Our role will be confined to providing the finance to PFI Sdn Bhd which is a MoF-owned entity," says an official with the provident fund (see accompanying story).

Good start crucial

Six months after the announcement of the 9MP and the PFI concept of financing infrastructure, the Government has come up with some ideas on how it is going to be undertaken.

The first phase will be jobs worth RM20 billion to be overseen by PFI Sdn Bhd. It will comprise mainly small jobs, essentially to cater for the small players in the construction sector.

The bigger jobs such as the Second Penang Bridge and the proposed bullet train are not part of the RM20 billion. Hence, these jobs will be undertaken on normal PFI terms where the risks and rewards rest with the private sector. The Government only decides whether or not it needs the facility and how much it is prepared to pay for it.

But what is crucial is that it executes the RM20 billion Government-initiated PFI jobs in the most efficient and transparent manner. Only then, can the other jobs be implemented well and without any draining of the Government's coffers. One way out of this is not to confine the jobs to small players. Let these be shared by all, big or small — as long as they are established and have a good track record.

The PFI may have been tested for more than a decade in developed countries, but the idea is just beginning to germinate in Malaysia.

Without Government-sanctioned guidelines yet, it is unclear whether Malaysia’s early PFI projects will manifest the key principles applied in PFI projects undertaken in developed countries. These are primarily providing value for money, defining who takes on what risks, specifying output and ensuring the best services are procured through competitive bidding.

Thus far, two companies — Ekovest Bhd and TSR Capital Bhd — have announced that they will be undertaking projects to build infrastructure on a PFI basis. Coincidentally, these facilities (to be constructed for use by the Ministry of Health and UiTM) will be located within a new TH Properties development in Sepang, known as Enstek. Both companies say their project values are still not final, while the exact requirements for the facilities have not been determined.

TSR, in a 70:30 joint venture with TH Properties, has proposed to the Economic Planning Unit (EPU) an estimated RM3 billion project to develop what it calls a Medical City. Envisioning a community of health and education sector professionals residing there, the development will be made up of a cluster of buildings comprising a medical faculty and hospital, research centres and residential homes.

TSR says it has engaged a foreign consultant who will produce the final concept and strategy for the Medical City. The hub must be able to attract medical and health professionals from around the world in order to be a success. The feasibility study will be completed in two months, TSR says. "It depends on the viability of the concept. If it’s not, the EPU may decide to go ahead with some but not all the elements of the project," says Lee Yat Kee, assistant general manager of TSR Bina Sdn Bhd.

Ekovest, in a joint venture with the Faber group, has won a contract to build a National Institute for National Products Vaccines and Biology for 9 Bio Sdn Bhd, a company wholly owned by the Ministry of Finance. Ekovest says the project was initially estimated to cost RM500 million, but this could go up due to modified requirements of the Ministry of Health — the ultimate user of the facility.

Upon completion, these facilities will be maintained by the respective joint ventures through a lease-rental agreement, which will be arrived at after factoring in the cost of construction.
Both companies are also seeking guarantees or an indication from the Government that the lease payments will be secure. This, of course, strays from the key principle of PFI projects where the party that operates and maintains the asset is paid for services rendered subject to its meeting expected standards.

In fact, both companies say, they do not see much difference in what is now termed PFI from the build-operate-and-transfer type projects of the past. “To us, it is a matter of terminology. It’s virtually like a concession but the outcome is that we can be quite certain that the facility will be used by the Government and not face the risks of under-utilisation, like tolled roads,” says an Ekovest executive.

Both companies stress the importance of minimizing payment risk to some form of guarantee in order for them to secure lower financing costs. “The risks of this project should be minimal if compared to other privatised jobs… Of course, a guarantee will help with our ratings,” says TSR’s Lee.

Despite there being some reservations about the structure of Malaysia’s version of the private finance initiative (PFI), there is probably one saving grace. The Employees Provident Fund (EPF) has stressed that it will not be exposing itself to any construction risk in the PFI structure.

“The EPF is taking part on the premise that it is a virtually risk-free investment on our part,” says an official with the provident fund. The EPF will be providing RM20 billion in loans to kick-start the country’s PFI. The loans are to PFI Sdn Bhd, a company established by the Ministry of Finance (MoF). As PFI Sdn Bhd is an entity owned by the MoF, it is highly improbable that the loans will go bad.

Ideally, contractors getting involved in PFI should be seeking their funding from the market. Hence, when the EPF was brought into the fray, there was concern that the provident fund would be providing financing to these contractors where banks did not want to. In the process, the risk is also associated with the EPF.

But EPF officials are not about to play that role. Instead, the EPF is seeking a virtually risk-free involvement in this project. In its current negotiations with the Government on the structure of the RM20 billion for the PFI, EPF officials will only be comfortable with lending the money to PFI Sdn Bhd.

PFI Sdn Bhd, which will be overseeing and undertaking the PFI programme, will in turn use the funds from the EPF to finance contractors who successfully bid for the PFI projects. The EPF feels that under this structure, it has an opportunity to achieve a virtually risk-free 5% to 6% return on its investment, which is the indicated interest rates of the loans it will be providing PFI Sdn Bhd. It is also understood that PFI Sdn Bhd could also be issuing bonds carrying a similar rate of return to EPF as a means for PFI Sdn Bhd to raise the money.

EPF: We Are Not Taking Any Risk

It is easy to fathom why the EPF is shying away from shouldering any responsibility other than providing PFI Sdn Bhd with the funds — the provident fund does not have the expertise to select projects and contractors and to play any kind of monitoring role. In fact, if the EPF played a bigger role in the scheme, it would probably come under fire.

While the RM20 billion represents a mere 6.6% of its total funds, it is still a significant amount of money. On the other hand, finding good investment opportunities is not easy these days, with the money market offering returns of about 4%.

“So from an investment standpoint, the PFI scheme makes good sense for the EPF,” notes an EPF official.

Owning the properties

In the PFI structure being formulated, the EPF could end up owning some of the assets after the tenure period of construction and maintenance is over. The asset could be transferred to the EPF as part repayment of the loan from PFI Sdn Bhd.

In such an event, the EPF official says, the provident fund will be very selective on which properties it will accept. There is also a possibility that PFI Sdn Bhd could assign the lease payments to the EPF. The EPF, under the past management, had made some bad investments. A case in point would be its corporate loans to companies such as Time Engineering and Realmild Sdn. Bhd. In lieu of payment of the RM500 million loan to Time Engineering, the EPF ended up with stakes in Time dotCom valued at RM3.30 a share. Time dotCom is today trading at 65 sen. As for Realmild, in lieu of its RM400 million corporate loan, the EPF ended up with a substantial stake in Malaysian Resources Corp Bhd. Hopefully, the current stance of the EPF is a firm indication that those days are gone.
Why PFIs Are Going To Face Problems

Big money by P Gunasegaram

The Government’s private finance initiatives (PFIs) of RM20 billion under the Ninth Malaysia Plan are going to face serious problems because they are designed to help contractors who would otherwise not get commercial financing. And they may not be PFIs at all.

While there may be capable small contractors who are unable to get bank financing and therefore are unable to obtain contracts, there are many such contractors who have managed to do so in the past but have shown gross incompetence in executing their projects.

The bumiputera contracting community is a strong lobby group within Umno but that does not mean the Government has to cater to them by putting together a scheme that will benefit them and give them access to funds when many of them may not deserve it. There are examples of even bigger bumiputera contractors who have both. The problem is, there are many who do not but have great connections.

There is one consolation about the proposed arrangement though. Thankfully, the Employees Provident Fund (EPF), that repository of the savings of employees, will not have a direct exposure to the PFIs (see accompanying articles). The EPF will advance up to RM20 billion to a wholly Government-owned company — PFI Sdn Bhd — and get a letter of comfort in return. It is a near-impossible scenario that a federal Government subsidiary would dishonour a loan from the EPF.

Still, such an arrangement exposes the Government directly to construction risk, which, under a standard PFI, will be moved to the private sector. Effectively, although perhaps not in the books, it manages a contingent liability of up to RM20 billion. Thus, it is a misnomer to name such an arrangement a PFI.

Under a PFI, a venture is planned, designed, built, financed and operated by the private sector in return for a steady stream of payments by the Government over a set period of time. Typically, Governmental involvement will be heavy at the planning stage and there will be a set of performance standards incorporated as well, based on which payment will be made.

The huge benefit to the Government will be that it need not concern itself with obtaining or channelling finance and just has to ensure that the job is completed to specifications and maintenance and operation are done to certain standards. These can be contracted out to qualified professionals to assess. In return, the Government pays an effective lease.

The conventional system is that the Government awards a contract and the contractor gets paid according to completion. The Government bears construction risk directly. The idea of the PFI is that the construction risk gets passed on to the private sector. The contractors get private financing, typically from the banks, on the basis of the strength of the contract with the Government. This operates almost like a concession, where the Government pays a continuous stream of money over a lengthy period in return for construction and maintenance.

Even under such an arrangement, it has been found in countries that used PFI that there are major problems in terms of project selection. This is because it is not always possible to plan building requirements 20 to 30 years ahead, which makes it very difficult or even nearly impossible for the Government to pull out of projects without paying massive compensation.

Most of the projects that are going to be funded under the proposed arrangement will be construction — of schools, hospitals and housing. PFI Sdn Bhd, which will get RM20 billion from the EPF from 2006 to 2010, is supposed to pay contractors on a “milestone” basis, presumably on completion of certain stages. PFI hence assumes the construction risk and will bear the loss if contractors are slipshod in their work or the project is delayed. Under a standard PFI, which this is not, the successful contractor will have to arrange the financing privately, based on the contract with the Government and his own ability and reputation, which is why it is termed PFI.

But here, we have a case where the Government not only procures the financing for the projects but also bears the construction risk. What kind of a PFI is that, if it exposes the Government to even greater risk than the current arrangement?