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PRIVATE FINANCE INITIATIVE (PFI) IN MALAYSIA: THE NEED FOR AND ISSUES RELATED TO THE PUBLIC SECTOR COMPARATOR (PSC)

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Abstract

The Concept of Private Finance Initiative (PFI) or Public Private Partnership (PPP) has been internationally implemented over the last two decades. In Malaysia, eventhough the involvement of the private sector in assisting with the provision of public services and facilities is not new, only recently under the Ninth Malaysia Plan the government officially announced the implementation of projects using PFI scheme in order to promote greater involvement of the private sector in delivering public services (Ninth Malaysia Plan, 2006). Consequently, a series of PFI projects is now being implemented including some already under construction. However, little is known on the real nature of the Malaysian PFI. One of the aspects considered critical in the implementation of a PFI project is the need for a public sector comparator (PSC) to demonstrate that the project can achieve value for money through comparing the public sector comparator (PSC) with the bid or bids submitted by the private sector. The study being reported herein focuses on the concept of PFI as practiced in Malaysia and the construction of a PSC. Given that under the Malaysian PFI, the PSC is yet to be established there is an urgent need for one to be constructed. In addition, critical issues concerning the transfer of risks and the determination of discount rate are also discussed. The study combines literature review on PFI and interviews with civil servants involved in the implementation of PFI in Malaysia.

Keywords: *Private Finance Initiative (PFI), value for money (VFM), Public sector comparator (PSC), risk transfer, discount rate.*

INTRODUCTION

The terms of Private Finance Initiative (PFI), Public Private Partnership (PPP) and Privately Procured Infrastructure (PPI) have been increasingly used in many countries. Although different terms are used, the common general concept is about the collaboration between the private and public sectors with the private sector having significant responsible in delivering public services. This policy has been internationally implemented over the last two decades. It offers an alternative to the conventional procurement of public service infrastructure and services.

For a typical PFI/PPP scheme there are several unique characteristics such as:

- i. *Service focus* – the main difference is in the change from considering buildings and infrastructure as ‘assets’ to ‘services’ provided by the private sector;
- ii. *Ownership* – the buildings are typically owned by the private sector during the period of the contract and leased back to the public sector client;
- iii. *Risk transfer* - some of the risk associated with the project must be transferred to the private sector. The determining factor of risk transfer is to transfer risk to the party who could best manage it;
- iv. *Innovation* - an output specification is used in which public sector clients specify their requirements in terms of the services required. Then, it is up to the private sector bidder to come up with a design that meets the public sector client’s requirements. Thus, it gives greater flexibility to the private sector provider to adopt innovation which leads to value for money (VFM) optimization;
- v. *Performance* – the payment to the private consortium is based on the extent that the required service is delivered and the client’s standard performance requirements are met (Ball et al. 2001 and Turner & Townsend Management Solutions 2002).

In Malaysia, even though the involvement of the private sector in assisting with the provision of public services and facilities is not new, only recently under the Ninth Malaysia Plan the government has officially announced the implementation of projects using PFI scheme in order to promote greater involvement of the private sector in delivering public services (Ninth Malaysia Plan 2006). Even though the first PFI project is now under construction, little information is publicly available on the true nature of PFI in Malaysia. This study therefore aims at exploring the concept of Malaysian PFI by conducting in-depth interviews with the relevant officers who are involved in executing PFI projects.

The principal aim for implementing PFI is to provide an improved form of public procurement which under right circumstances could yield improved efficiency savings and greater value for money than traditional procurement (Robinson 2000).

In other words, for a project to go ahead with a PFI option, it needs to demonstrate better value for money when comparing the private sector bids with a detailed public sector comparator (PSC) (Treasury Taskforce 1997). In assessing VFM of a project, PSC is one of the crucial elements to be considered. From Malaysian context, even though the government acknowledges the importance of VFM assessment in implementing PFI projects, a robust PSC framework is yet to be established (Ninth Malaysia Plan 2006). Realizing the significance of having a valid PSC to accurately assess VFM, this study also attempts to develop an appropriate framework of PSC that suits the Malaysian environment. However, at this very initial stage the study only focuses on the principle components of PSC models for PFI projects established in different countries particularly the UK, Australia, and Canada. The information was obtained through a thorough review the official documents on PSC construction of these countries.

This paper is structured as follows. Section 2 discusses the concept of private finance initiative (PFI) in Malaysia. Section 3 offers information on the public sector comparator such as its definition, importance and also brief of comparison PSC's components between countries. Then, the following section (Section 4) discusses the controversial issues concerning the construction of a PSC. A special reference was made to the situation experienced by the United Kingdom. Finally, Section 5 summarizes and concludes the findings of this study.

THE PRIVATE FINANCE INITIATIVE IN MALAYSIA

PFI is an essential economic policy that has been globally adopted as it is the current trend towards greater private sector involvement in the management, delivery and financing of public services (Dixon et al. 2005). It is a means of using private finance and skills to provide public services which were traditionally provided by the public sector. In the purest form of PFI contract the private sector is responsible for designing, building, financing and operating facilities based on output specifications determined by the public sector. In effect, the public sector does not own the assets but has the obligation to make regular payments to the private sector providers for the use of facilities throughout the contract period of normally 25 to 30 years (Heald 1997; Hall 1998 and Broadbent and Laughlin 1999).

The involvement of the private sector in delivering public facilities and services is not new in Malaysia. It existed since mid 1980s as a result of the adverse impact of the world economic recession that caused government to seek assistance from private sector for the development and economic activities of the country. Malaysian incorporated and privatization are among the economic policies introduced to foster the involvement of the private sector.

Privatization is one of a vital component of the government's economic policies which aims at reducing the government's administrative and financial burdens. The Malaysian government officially embarked on privatization in 1983. The policy was aimed at fostering greater involvement of the private sector in delivering public sector projects. Generally, privatization has been defined as the transfer of enterprise ownership from the public to the private sector. Kay et al. (1986, 2) identified three interrelated policies under the umbrella of the privatization program. These include: 1. Denationalization: the sale of the public assets to the private sector; 2. Liberalisation or deregulation - the opening of the state activities to private sector competition and 3) contracting-out or franchising - the contracting out of public provision to private firm. From the Malaysian context, the scope of privatization is even broader (Jomo and Syn 2003). The various modes of privatization applied in Malaysia include i) sale of equity; ii) sale of assets; iii) lease of assets; iv) management contract; v) Built-Operate-Transfer (BOT) and vii) management buy-out (Economic Planning Unit 2006).

The government reported positive outcomes from privatization policy in helping the government to reduce financial and administrative burden and also to improve efficiency in the provision of public services (Jomo and Syn 2003; and Siddiquee 2006). It was reported in the Eight Malaysia Plan that more than RM28 billion of the government's capital expenditure was saved as a result of privatization (Eight Malaysia Plan 2001).

Subsequently, in strengthening the role of the private sector as the engine of growth, the Private Finance Initiative (PFI) scheme was unveiled in Malaysia under the recent Ninth Malaysia Plan (9MP). The PFI is formally defined in the Ninth Malaysia Plan report (2006) as:

'the transfer to the private sector the responsibility to finance and manage a package of capital investment and services including the construction, management, maintenance, refurbishment and replacement of the public sector assets which creates a stand alone business. The private sector will create the asset and deliver a service to the public sector client. In return, the private sector will receive payment commensurate with the levels, quality and timeliness of the service provision throughout the concession period' (Ninth Malaysia Plan, 2006)

In brief, under the PFI project, the private sector funds and builds the asset, while it is the obligation on the part of the government is to purchase a flow of services over time rather than the capital asset that provides the services.

The principal objective for embarking on PFI in Malaysia is to revise and to improve on the implementation process of the existing privatization policy (Ninth Malaysia Plan 2006). As tabled in the 9MP, the PFI will be employed for infrastructure and services development projects in two situations. **First**, PFI will be

utilized if it could make government projects more efficient, where risks and rewards are optimally shared between the government and the private sector. **Secondly**, PFI is to be used where government support enhances the viability of the private sector projects in strategic or promoted areas (Ninth Malaysia Plan 2006).

In a speech by the Second Finance Minister, Tan Sri Nor Mohamed Yakcop at the Private Finance Initiative Seminar which was held on the 10th November 2006, he said that:

'..in the Malaysian context, we view PFI in the broadest of terms, as capturing a wide spectrum of options that lie between the two extremes of privatizations and government project'.

From the interviews with the government officials conducted by the researcher, it is understood that there are two formats of PFI schemes in Malaysia. This similar information has also been announced by the Prime Minister of Malaysia, Datuk Seri Abdullah Ahmad Badawi and was reported in the local news paper (The Star Online, 20th July 2006).

In the first format, the private sector would construct the asset or building and leases it to the government for a specified fixed period of time. A special purpose vehicle (SPV) named PFI Sdn. Bhd. has been set up to take on the responsibility for implementing the PFI projects using this format. This SPV is wholly owned subsidiary of the Ministry of Finance. The PFI Sdn. Bhd. is accountable for executing government's identified projects. Essentially, the projects are mainly the initial 425 projects that worth RM20 billion which have been identified by the government to be delivered via this format of PFI under the 9MP.

In terms of finance, the Employees Provident Fund (EPF) has been required by the government to provide loan to the SPV. The SPV (i.e. PFI Sdn. Bhd) will utilize this allocation from EPF to finance the selected contractors for the construction of the assets. Once the assets have been built and ready for operation, the SPV will lease the assets to the Federal Land Commissioner (FLC) which acts as a middle-man between the ministry which has requested for the project and the SPV. In return, the relevant ministry (i.e. the government) will pay lease charges to the SPV through the Federal Land Commissioner. Throughout the contract the SPV will own the assets and will service the loans given by the EPF. After the expiry of the contract periods, the assets will be transferred to the government at no cost.

During the interviews the researchers were informed that in contrast to the first format, the second format requires the private sector to identify the projects that are deemed to be economically viable and would benefit the public to be executed via PFI schemes. Under this format the private sector concession is fully responsible for designing, building, financing and operating the public service facilities. In fact, this

format of PFI is similar to the purest form of PFI that was predominated in the UK since 1992. An example of project carried out using this form is the Second Penang Bridge project which has been awarded to UEM Group. The 24 km bridge which will connect Batu Kawan in Seberang Perai and Batu Maung on the island with an estimated cost of RM2.8 billion is currently under construction (The Star Online, 3 August 2006). The bullet train between Kuala Lumpur and Singapore project which is currently under government consideration is another example of project of this PFI format.

Overall, PFI in Malaysia is a new and unique mechanism unlike other concessions that have been used in the past. As it is still at the early stage of PFI implementation, a constant review and revision to the current PFI arrangement in should be welcomed to improve the government's approach to PFI in achieving the objective of introducing the best of private sector skills and practices to contribute to a higher sustainable level of development and economic growth of the country. Also, the government should seek advice from PFI experts both locally or internationally on the critical aspects of PFI implementation that are still lacking such as the proper procurement procedures and the construction of public sector comparator that is crucial for the assessment of value for money of PFI projects since. As Malaysia is yet to develop a PSC, the following section provides information about PSC together with a brief analysis on the comparison of PSC between three countries (i.e. United Kingdom, Australia and British Columbia). Also, debatable issues on the reliability of PSC are discussed in the subsequent section.

THE PUBLIC SECTOR COMPARATOR (PSC)

A PSC is defined as 'a hypothetical risk-adjusted costing, by the public sector as a supplier, to an output specification produced as part of a PFI procurement exercise'. It is expressed in present value terms and is based on the recent actual public sector method of providing the defined output which involves the estimation of the construction costs, running costs and more crucially the value of risk to be transferred to the private sector (HM Treasury 1999).

The objective of a PSC is to promote full cost pricing at an early stage in the procurement process. Also, it acts as a benchmark and evaluation tool in ensuring efficiency of the procurement process. A PSC is required for the assessment of the value for money (VFM) of a PFI project. A project needs to prove as providing better before it can be delivered via PFI. VFM is assessed by comparing the costs of the proposed PFI project against a public sector comparator (PSC). A project is considered to provide good VFM if the net present value of the PFI bid is lower than the PSC. This is why PSC is needed. This importance of PSC is pointed out by

Jeremy Coleman, the Auditor General of the UK National Audit Office (NAO). He states that:

'The Public Sector Comparator (PSC) is a key part of the financial evaluation of proposed PFI project. The PSC is an important guide to judgment of the overall VFM of a PFI project.' (HM Treasury, 1999).

More importantly, the derivation of PSC is complex because it takes into consideration the qualitative factors such as risks involved and types and quality of services provided rather than concentrating only on the quantitative factors (Treasury Taskforce 1999: para. 2.3.3). The UK Treasury Taskforce (1998: para. 2.2.1) claims that the process of building a PSC inevitably focuses only on the factors that can easily be quantified and expressed in monetary terms. Other factors, notably risk transfer, service quality and wider policy objectives are less easy to quantify and may not be fully reflected in the comparator. Due to the limitations involved, the Treasury Taskforce (1998: para. 2.2.4) highlights that a PSC that is lower than the PFI bid should not always imply automatic rejection of the PFI bid.

In other words, in seeking for a more analytically rigorous VFM appraisal mechanism, VFM should not be considered as a pass or fail test before all other non-quantifiable factors which involve both the benefits and costs of the option have been taken into account (Treasury Taskforce 1999). A study on PFI VFM assessment by Mumford (1998) identified six sources of cost saving that could be achieved from PFI contracts as compared to conventional procurement projects which might help to achieve VFM. These include: i. clearer definition and specification of user needs; ii. more careful lifetime design and costing by the constructor; iii. speedier construction and commissioning; iv. More effective monitoring of contracts; v. incentives that better align effort with risk and rewards; and vi. decision making that better exploits asset compatibility. Moreover, the study by Arthur Andersen and Enterprise LSE (2000: 18-19) which was commissioned by Treasury Taskforce identified six key drivers to VFM as follow: risk transfer, output based specification, long term nature of contract, performance measurement and incentives, competition and private sector management skills.

Despite the need to consider the qualitative factors, PSC remains crucial in undertaking VFM assessment. In Malaysia, the PSC is yet to be constructed. This was acknowledged in the Ninth Malaysia Plan report as follows:

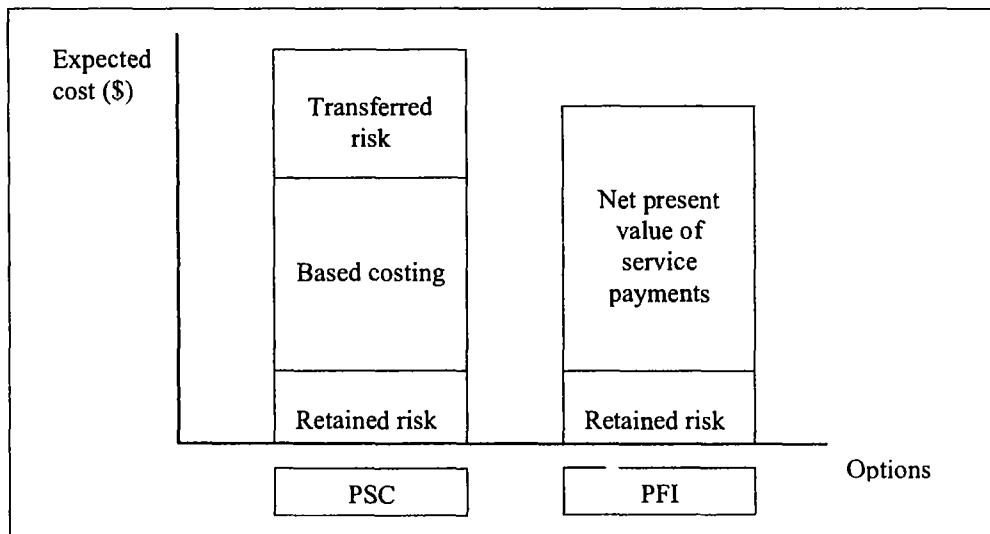
"As the evaluation and procurement process involved in implementing PFI will be more elaborate, particularly the need to be clear about output specifications, maintenance, performance indicators and distribution of risks, an effective enabling framework for implementation will be developed. In this regard, steps will be undertaken to establish the public sector comparator in evaluating the proposals and determining the value for money as compared to the conventional approach" (Ninth Malaysian Plan, 2006: 230)

When constructing a PSC for Malaysian PFI project, the government should consider incorporating both the quantitative and qualitative factors so that a more reliable VFM appraisal outcome is obtained. In contributing towards the process of establishing a model of PSC for PFI projects in Malaysia, this paper briefly analyses the key components of a PSC with reference to the PSC established other countries particularly in the UK, Canada, and Australia.

A comprehensive review of relevant documents on PSC development in the UK, Australia and Canada revealed that there are three common core components of a PSC. These include base costing, transferred risk and retained risk as indicated in Figure 1. For the PSC in Australia, competitive neutrality is explicitly considered as another key component. *Competitive neutrality* adjustments remove any net competitive advantages that accrue to a government business by virtue of its public ownership. This is to allow a fair and equitable assessment between a PSC and PFI private bidders (PPP Victoria 2001). Examples of competitive neutrality adjustments are insurance costs for assets and services that are typically not insured by a public sector entity as it was deemed from a risk management perspective to self insure the facilities. For PSC in Canada, this is called hidden or assumed cost and considered as part of an indirect cost element of the base costing.

Based costing is the estimation of the basic procurement costs which covers capital costs and operating costs. Capital costs are costs needed to construct or build the facility. These include costs incurred for the design, construction, purchase of land, material, and plant and equipment. Basically, capital cost represents a huge

Figure 1
Comparison between PSC and PFI



cost component of a PSC. The estimation of capital cost should reflect recent actual practice in the public sector using existing plans for a site or the likely approach.

On the other hand, operating costs are the costs of providing the services specified in the procurement over the contract period. These include full staff costs, raw materials and consumables, repairs and maintenance and administrative overheads. As the effect of inflation throughout the contract period may be significant, all costs should be expressed in the prices of the base year of the comparison (the effects of expected future inflation should be excluded).

Another crucial but controversial component of a PSC is the risk element. Gallimore et al. (1997) state that the distinction between reality and possibility is an essential element of risk. More specifically, from a financial perspective, risk is taken to be the variance of returns around the expected return (Gallimore et al., 1997). Pollock and Vickers (2000) argue that risks play a major role in determining the VFM of a PFI project. Froud (2003) has a similar view on the importance of risk in verifying the VFM achieved from PFI. Besides, he also points out the significance of risk in the accounting treatment of PFI projects.

There are seven principal risks relevant to PFI being identified by the Treasury Taskforce (1997: para. 3.21) in their publication, *'Partnership for Prosperity'*: Design and construction risk; commission and operating risk; demand for volume/usage risk; residual value risk; technology/obsolescence risk and regulation and legislation risk. These risks were also commented on in the Private Finance Panel publication (1996), *'Risk and Reward in PFI Contracts'*. For each type of risks, there are three possible choices to be made: i) To be retained by the public sector; ii) To be transferred to the private sector; and iii) To be shared between the two sectors.

The underlying principle behind the distribution of risk among various parties under PFI schemes is that the risk should be taken by those most able to control it, and this will result in cost reductions brought about through increases in efficiency and innovations introduced by the private sector (Ball et al. 2000). In other words, a more efficient allocation of risk between the private and public sector would yield a greater VFM in the provision of public services (Hall 1998; Bing et al. 2005).

Transferable risks are those that are likely to be transferred to private sector bidders. The type and number of risk which are to be transferred need to be assessed on a project by project basis. The value of transferable risk in a PSC measures the cost government would expect to pay for that risk over the term of the project in a public procurement scenario. Alternatively, retained risks are those risks that are managed more efficiently within the government. For projects where retained risk is included in the PSC, its value will also need to be added to each of the private bids to allow a meaningful comparison.

As PSC is expressed in present value terms, another main issue in developing a PSC, particularly with the VFM valuation is the determination of the hurdle rate to use for discounting the cash flows (Pollock and Vickers 2000). In other words, once all the components of the PSC have been added up, they need to be discounted using an acceptable discount rate to reach at the net present costs before comparison with the net present costs of the private sector can be made. From a review of the official documents, it was realized that different countries apply different discount rates to work out the present value of the cash flows. Furthermore, in Australia and Canada, various rates are used for the different sectors of PFI projects available in their countries. Only the United Kingdom, applies a uniform discount rate across sectors though the rate has been changed from 6 per cent in the past to 3.5 per cent at present. Table 1 below indicates the discount rates use in the UK, Australia, and Canada.

Table 1
Discount Rates Used in Different Countries

	United Kingdom	Australia	Canada
In the past	6% (real rate) Standard rate for all projects	8.65% (after tax nominal rate) Standard rate for all projects	Different rates for different projects based on private sector's cost of capital
Current	3.5% (real rate) Standard rate for all projects	Different rates for different projects sector	

Generally, the selection of the discount rate for the net present cost (NPC) is a subjective issue and it requires an understanding of the relationship between risk and return. Due to the subjective justifications for selecting an appropriate discount rate, the reliability of the PSC is always been a subject of criticism. The key issues regarding the determination of discount rate as well as the transfer of risks issues are discussed in the next section.

CONTROVERSIAL ISSUES ON PUBLIC SECTOR COMPARATOR

One of the controversial areas of a PFI contract lies in the transfer of risk to the private sector. The process of risk transfer is central to PFI schemes because a privately financed option is unlikely to represent value for money before risk transfer. This is because as risk is transferred to the private sector, *ceteris paribus*, the cost of the transferred risk is added to the PSC (Wynne 2002). This adjustment will cause the PSC value to be relatively more expensive than a privately financed alternative. For example, an evaluation of the NHS hospitals under PFI scheme by Froud and Shaoul (2001) shows that a greater VFM is achieved when some of the risks associated with construction of the hospital and its subsequent management is transferred to the private sector provider. The finding from Arthur Andersen and Enterprise LSE (2000, 53) study also reveals that 60 percent of the average 'saving' is contributed by the transfer of risk.

However, the amount of risk to be transferred is a matter of ambiguity. This is due to the complexities involved in the valuation of risk. Risks need to be identified and their impacts on costs need to be assessed. It also requires the estimation of the probabilities and the re-examination of the estimates using sensitivity analysis. Moreover, risks should be appropriately allocated between the private and the public sector. An inappropriate risk transfer will reduce the VFM achieved as the party will seek to alleviate the impact of the risk by charging greater premium (Treasury Taskforce 1999: para. 2.4.9).

According to NAO (1999e: 52), the policy of risk transfer has shifted from an early recommendation of 'maximum risk transfer' to an 'optimal risk transfer'. At present, the principle governing risk transfer is that;

'Risk should be allocated to whoever is best able to manage it. Although there may also be policy reasons to encourage risk transfer, the aim is to achieve optimum risk allocation, not transfer risk for its own sake'

In practice, risk is not a simple uni-dimensional commodity that can be costlessly assessed and completely transferred to the private sector (Mayston 1999). The relationship between risk and VFM is that as risks are transferred to the private sector, VFM may rise until it reaches the optimum level, where any further risk transfer might cause a fall in the VFM. This is because risk transfer becomes inefficient since the private sector may be unable to absorb risk properly (Forshaw 1999).

A study by Broadbent and Laughlin (1999) argues that there are uncertainties in the issue of risk transfer. The main queries include the types of risks involved in the PFI project, the risks that need to be transferred and the characteristics that

demonstrate when a risk is actually residing with a particular party. Subsequently, the Treasury Taskforce (1997a: para. 3.23) concluded that;

'As a general rule, PFI schemes should transfer to the private sector risks where the supplier can influence the outcome. The supplier is able to influence the likely performance of the building and its services by the quality of the design, construction and refurbishment work undertaken. The quality and frequency of maintenance also has an important bearing on on-going performance. Therefore, risks transferred will include design, build, financing and operating risks'.

Landers (1996) agrees with the idea and similarly suggests that PFI requires an appropriate transfer of risk to the private sector, both through the design, planning and construction phases and in operation and also through a combination of payment mechanisms and specific contract conditions. Wynne (2002) also points out that there are two types of risk often cited as transferred to the private sector contractor under a PFI project. They are risks related to delay in completing the project and risk of cost overrun for a project. Nevertheless, according to Mayston (1999) a large part of the risk which the PFI contract may seek to transfer to the private sector relates to demand risk.

From the perspective of the IPPR, design and construction risk and operating cost risk should be borne by the private sector. While political risks which involve policy changes should be borne by the public sector. But, certain risks which are difficult to specifically allocate between the parties, such as demand risk and obsolescence risk, need to be appropriately shared among the two parties (IPPR, 2001). Likewise, the research findings by Bing et al. (2005) suggest that the public sector should retain political risks as well as site availability risks. On the other hand, risks which are directly associated with the project itself should be transferred to the private sector.

Akintoye et al. (1998) carried out a research project aimed at obtaining feedback from three different groups involved with PFI projects (Public sector (clients), contractors, and lenders) on the issues of risk burdens and risk analysis and the management of PFI schemes. The results from their questionnaire survey show that the respondents tend to rank most highly those risk factors that were highly related to their own business objectives. Also, the results show that all the three parties adopt different methods and techniques for risk assessment and approach risks in different ways. However, one thing they have in common is that all parties have insufficient knowledge of PFI to ensure its success. Similarly, Gallimore et al. (1997) prove that certain risks are differently perceived by participants. They also emphasize that an attempt to measure and expose these differences is a difficult area of study because it involves the quantification of data that are frequently qualitative in nature.

Froud and Shaoul (2001) and Wynne (2002) point out that even though issues of risk analysis and risk transfer are important in PFI, official guidance on how to calculate the risk transferred is insufficient. Moreover, publicly available evidence is also typically very limited. Their evaluation on a number of FBCs suggests that no valid methodology for risk transfer has been applied. As a result, different business cases use different methodologies to transfer risk.

Recently, a research study carried out by a group of researchers commissioned by the Association of Chartered Certified Accountants (ACCA) (2004) suggests that even though risk transfer is the central element in justifying VFM, their investigation indicates that risks have not been transferred to the party best able to manage it. The study which evaluates the operational performance of PFI scheme in roads and hospitals also highlights that;

'...rather than transferring risk to the private sector, in the case of roads DBFO has created additional costs and risks to the public agency, and to the public sector as a whole, through tax concessions that must increase costs to the taxpayer and/or reduce service provision. In the case of hospitals, PFI has generated extra costs to hospital users, both staff and patients, and to the Treasury through the leakage of the capital charge element in the NHS budget. In both roads and hospitals these costs and risks are neither transparent nor quantifiable. This means that it is impossible to demonstrate whether or not VFM has been, or indeed can be, achieved in these or any other projects' (ACCA, 2004).

In short, the process of attempted risk transfer itself may lead to long and complicated PFI contracts, adding to the evaluation, transactions, negotiation and monitoring costs involved, which can significantly reduce the attractions of privately financed projects.

The second controversial issue concerning a PSC is the determination of the discount rate for the purpose of discounting the PSC costs to get the time value of money of the costs. In particular, the use of a single rate to discount both public and private sector schemes would mean that the risk of both schemes is equal. Broadbent *et al.* (2001) highlight that some people argue that this may not be the case. Implicitly, these people assume that the public sector has a lower risk. The analysis by Grout (1997) reveals that the public provision is valued from the cost side that is the present value of the cash flows of the costs of the project. Whereas the private provision is from the revenue side; the present value of the cash flows of the revenue of the project. Revenues are generally perceived to be more risky than costs and this implies that the public sector should use a lower discount rate.

In addition, the time profile of the expenditure incurred by the public sector might differ substantially between the traditional procurement and the PFI. The capital expenditure under traditional procurement is incurred as the investment

project is undertaken, whilst under PFI the costs are spread over a 25 to 30 year period. When comparing the PFI against the PSC to determine VFM, the use of a relatively high discount rate, places more weight on the near future as compared with the more distant future, and this will result in a lower cost for PFI hence a better value for money. On the other hand, a low rate of discount tends to favour the PSC or the traditional procurement.

As in the case of the United Kingdom, Wynne (2002) claims that the 6 percent discount rate used since 1992 does not reflect the actual current economic situation. This is because the same rate has been used despite the significant fall in general interest rates over the last few years. There are various arguments that have been put forward with regard to the discount rate issue. Wynne (2002) in his analysis shows that none of the first 11 PFI schemes in the NHS would be considered to provide VFM if the discount rate used had been changed to 5 percent instead of the normal rate of 6 per cent. Similarly, Gaffney et al. (1999) use the case of Carlisle hospital to prove the sensitivity of VFM to the discount rate used. Their study indicates that at a 6 percent discount rate, the PFI scheme is slightly cheaper than traditional procurement. However, when the discount rate is reduced by only 0.5 percent, the outcome of the appraisal is reversed to favour the traditional method of procurement. In other words, both Gaffney et al. (1999) and Wynne (2002) demonstrate that small changes in the discount rate applied will vary the outcome as to which scheme offers the best VFM.

Concerning this discount rate issue, Grout (1997) and Smith (1999) consider whether the use of more sophisticated models such the Capital Asset Pricing Model or the Arbitrage Pricing Model could provide a better basis for deciding appropriate discount rate. Sussex (2001) claims that four per cent discount is a better reflection of the time preference rate. Subsequently, in January 2003, the Treasury had agreed to reduce the discount rate for the purpose of economic appraisal to 3.5 percent. However, there are still debates on these issues at present.

In light of the above critics of PSC, fundamental lessons should be learned from the experiences of other countries and serious consideration must be given on the matters concerned when developing a PSC for the PFI projects in Malaysia.

CONCLUSIONS

The introduction of PFI in Malaysia under the 9MP is the continuation to the existing privatization policy which has been implemented since the early 1980s. As the implementation of PFI in Malaysia is still at the infancy with only several projects currently under construction or at the evaluation stage, the government should closely look into the critical aspects of PFI that are still lacking such an effective enabling

framework and mechanism for procurement and evaluation process. To be specific, a PSC which is a crucial element in VFM appraisal is yet to be established. However, in developing a PSC framework for PFI projects in Malaysia, many factors need to be scrutinized to ensure its suitability to the Malaysian context. Also, a special PFI regulation body is essential to be set up to regulate and monitor the progress of the scheme.

Moreover, since a PFI approach is required to prove better VFM before it can go ahead, a great reliance will be placed on the technical judgments underpinning the PSC costings. The complexity involved in the development of the PSC has led to a greater inherent uncertainty and subjectivity associated with aspects of the PSC estimates (Audit Scotland 2002 and Audit Commission 2003, 34). Wynne (2002) highlighted the value of risk transferred to the private sector as one of the key subjective area in developing the PSC. Research by Pollock et al. (2002), Audit Scotland (2002, 68) and Audit Commission (2003, 35) proved that a better VFM of PFI option was only achieved when adjustment for risk transfer has been made. This is because the cost of the risk transferred to the private sector is added to the cost of the PSC and cause it to be higher. In addition, it was also claimed that the PSC has overestimated the finance cost of public funding (Audit Commission 2003, 34). Subsequently, the reliability, accuracy and relevance of the PSC have been the subject of considerable debate (Audit Commission 2003, 37).

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