

# POTENTIALS OF PFI/PPP AS A FINANCING SOURCE FOR PUBLIC SERVICES PROJECTS IN SAUDI ARABIA

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Toward the end of 2002, the Saudi Arabian government announced its budget for the year of 2003. The public deficit was nearly 95% of GDP, and government endeavours to diminish this deficit have not yet been successful. At the same time, demand for more public services is increasing due to the rapidly growing population. The objectives of this paper are to firstly highlight the potential roles PFI/PPP could play in Saudi Arabia by reviewing economic figures, budget indicators and government steps towards such new procurement methods. Secondly, the paper refers to the UK's experience in adopting PFI/PPP as a strategic solution for providing and modernising infrastructures and services. The paper presents a questionnaire that was designed to assess the feasibility of transferring PFI/PPP to Saudi Arabia. The results confirm the potential for implementing Private Finance Initiative in Saudi Arabia.

Keywords: Projects finance, PFI/PPP, Public services projects, Saudi Arabia.

## INTRODUCTION

Traditional forms of procurement are no longer the only methods that a government can use to procure projects (Levy, 2002). The efficiency of Private Finance Initiatives (PFI) in providing the required services projects when the government cannot provide them due to the lack of available capital is no doubt enormous. The UK government is considering this method of procurement as a corner stone in modernizing its public services (HM, 2000).

After decades of state dominated economic activity, many governments around the world are coming to rely increasingly on the private sector to foster growth (Shawki, 1998). Applying PFI in other countries has been successful in many countries (Lourdes and Vicente, 2001; Edward and Dick, 2001). Yet in Saudi Arabia, although the government is calling for the participation of the private sector in the development process, the PFI has not been implemented correctly even though there have been some attempts at implementing it in a different way.

PFI has been used in providing service projects in the UK since 1992; many projects are now in operation under such agreements, and PFI helps provide services with value for money for both the government and the end user. The work presented in this paper aims to investigate the potential opportunity and applicability of using the same procurement method in providing service projects in Saudi Arabia.

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## NEED FOR SERVICES PROJECTS IN SAUDI ARABIA

The latest indicators show that the population of Saudi Arabia in the year 2000 was 22.01 million compared with 1999 when the population was 21.33 million (Al-Riyadh, 2001). This represents a growth rate of 3.2% in the kingdom, which is relatively high by international standards (Planning, 2003).

Coupled with this population growth is the increasing need for service projects. It is estimated that there is a need for 850 new schools to be opened every year (Abu Hlaigah, 2002). This means opening more than 2 new schools on average every day. Generally, more than 50% of existing schools are in properties rented from the private sector (Table 1).

Type	Number of schools	Private ownership buildings (rented)	Governmental ownership
Boys	10,034	5,161	4,873
Girls	10,227	5,200	5,027
Total	20,261	10,361	9,900
%	100.00%	51.14%	48.86%

Table (1) Number of schools and the ownership of properties, Basic Education (Al-Bassam, 2002).

At the same time, there is a growing need for services such as hospitals, electricity, water supply, sewage networks and treatment plants, transportation, etc. For example, in its report about the long-term prospects for Saudi Arabia, The Ministry of Planning (Planning, 2003) indicated that the demand for municipal water was expected to increase from 1.8 billion cubic meters (bcm) in 2000 to 2.03 bcm in 2004 and to 3.10 bcm in 2020, thus giving an average annual growth rate of 2.8%. The Saline Water Conversion Corporation (SWCC), which supplies 50% of all municipal water in the Kingdom, will not be able to meet these targets unless there is massive investment in new desalination plants (IPWA, 2001).

In addition, according to a Ministry of Planning report (Planning, 2003), the total demand for additional housing units for these years (2000-2004) is expected to reach 800,000 units. In the long term, population growth over the coming two decades is expected to increase total demand to 3.9 million additional housing units. The demand for Electricity as the peak load (maximum daily demand for electricity) is expected to reach about 59 million kilowatts (mKW) in 2020 as compared with 21 mKW in 1998, implying an average annual growth rate of 4.5%. To meet this increased demand, actual generation capacity during this period would be required to increase from about 21 mKW to 70 mKW.

Therefore the need to refurbish and construct the required official buildings is obvious, even with the shortage of studies and surveys; most government departments are using rented properties not originally designed to meet their requirements.

## ECONOMY AND PRIVATE SECTOR IN SAUDI ARABIA

The Saudi economy is characterized by a limited industrial output and a dependence on primary products. Oil became the key product in terms of earning power, during the early 1970s (Al-Otaibi, 1999) and following the peak years of oil revenues in the early eighties, it became necessary to undertake a very considerable downward

adjustment in the government's level of spending. At the same time, the economy as a whole had to come to terms with these more modest circumstances. The remarkable feature of this process is the relative ease with which both the government and the private sector came to terms with the new circumstances (Saudi Information, 2003).

In order to counter the potentially adverse effects of explosive demographic growth, high unemployment and declining living standards, the government has taken measures to liberalize trade; privatising certain sectors of the Saudi economy and attracting foreign investment. While these reforms are clearly necessary in the medium and long term, in the short term the Saudi economy will continue to be driven by oil prices and OPEC supply policies (Deutsch Bank, 2002). Saudi Arabia has the largest reserves of petroleum in the world (26% of the total amount) and its petroleum sector accounts for roughly 75% of budget revenues, 40% of GDP, and 90% of export earnings (WFB, 2000). Nevertheless, the Saudi economy is facing a public deficit in the budget with government expenditure higher than revenue. Table (2) shows the budget deficit that has been a standard feature of the economy for many years.

Year	Revenue	Expenditure	Deficit
1984	55.04	61.39	6.35
1985	45.73	57.71	11.97
1986	35.63	49.07	13.44
1987	20.40	36.67	16.27
1988	27.68	35.97	8.29
1989	22.56	39.87	17.31
1990	30.56	56.11	25.55
1991	41.25	71.04	29.79
1992	43.17	62.00	18.83
1993	44.11	54.80	10.69
1994	37.71	43.68	5.97
1995	34.40	43.68	9.28
1996	39.07	46.37	7.31
1997	47.76	52.83	5.07
1998	54.80	59.01	4.21

Table (2) Saudi Arabian Budget Deficit (Billions US\$) (Al-Khateeb, 2000)

Privatisation itself is not new in Saudi Arabia, and Saudi Arabia has a history of being very innovative in its approaches to involve the private sector in key economic activities. As early as 1933, the Saudi government was already contracting out its oil operations to the Standard oil company via the formation of ARAMCO (Al-Sarhan, 2001). However, the formation of the Supreme Economic Council (SEC) in September 1999 was intended to bring about greater qualitative and quantitative economic growth. On June 4, 2002, the SEC approved a series of measures aimed at promoting the activities of the private sector with the aim of achieving greater national economic growth. The decisions taken not only provided for the privatisation of some

state-owned entities but also facilitated private sector involvement in areas that had previously been the exclusive domain of the government (Saudi Newsletter, 2002).

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP	120.01	127.64	157.53	164.77	145.77	160.96	188.44	186.24	185.33	186.93
Gov. Debt	91.2	105.87	132.27	143.47	169.07	166.67	164.27	170.67	173.33	177.6
%	76%	83%	84%	87%	116%	104%	87%	92%	94%	95%

Table (3) Percentage of government debt to the GDP. (Billion US\$) (SAMBA, 2003).

The Council of Ministers Decision (August 6, 1997) specified eight objectives of privatisation in Saudi Arabia and selected the principles to be taken into account in order to achieve these objectives. The general objectives and strategic principles of the Seventh Development Plan (2000 – 2004) defined these eight objectives under an overall strategic objective as ‘increasing the participation of the private sector in activities related to economic and social development.’ The third strategic principle was ‘To continue the policy of enabling the private sector to carry out many economic and social functions, provided that this results in real benefits in terms of reduced cost, good performance, and employment of citizens (U.S.-Saudi, 2002). In November 2002, the Council of Ministers added momentum to the long-discussed privatisation plans by approving privatisation in varying forms and degrees for some 20 areas of commercial activity now being conducted by the government. These areas include telecommunications, electricity, water desalination, air transportation, airport services, mail services, highway management, railways, some health care services, some educational services, and hotels (SAMBA, 2003).

## **PFI: THE UK’S EXPERIENCE**

Throughout the 1980s and 1990s, the UK saw a number of initiatives to bring the private sector into activities once considered the sole preserve of the Government – first through the programme of privatising state-owned industries and the contracting out of public sector activities, and then through the use of private sector management and funding for public sector projects through the Private Finance Initiative. However, all too often, these early approaches were based on the assumption that the best solution to public sector problems was simply to transfer as much of the activity as quickly as possible to the private sector (HM, 2000). PFI, PPP and other initiatives can collectively be placed under the heading of privatisation, which was introduced by the Conservative Government, and then applied with increasing frequency in the 1980s and 1990s (Paul *et al*, 1997). The Private Finance Initiative (PFI) is the name given to the policies announced by the Chancellor of the Exchequer in the Autumn Statement of 1992. His intention was to bring the private sector into the provision of services and infrastructure which, formerly, had always been regarded as primarily ‘Public’. The changes involved a relaxation in the rules governing financially freestanding projects; the encouragement of joint ventures between public and private sectors; and an undertaking that the government would look for further opportunities for the private sector to provide capital-intensive services to the public sector (RICS, 1995). This approach is being increased in many developing countries where the high demand for infrastructure development coupled with the pressures on national budgets has resulted in governments moving towards encouraging the private sector to invest

in infrastructure projects in the forms of Build Operate and Transfer (BOT), or its other variants (Ahadzi & Bowles, 2002).

PFI as a procurement system was introduced to benefit from the efficient management of the private sector in a commercial way regarding dealing with assets. Therefore, efficiency of facilities and value for money are the foundation of this policy, from programming for the design to the end of the contract. All the characteristics of PFI (such as innovation in design and operation, application of life cycle cost (LCC), sustainability, quality of performance and risk transfer) taken as a whole make PFI not only a procurement system, but also a tool for developing the construction industry through innovation and perfecting process.

A cardinal principle or philosophy behind the PFI is that it is intended to transform government departments from being owners and operators of assets into purchasers of services from the private sector. The private firms then become long-term providers of services rather than up-front asset builders, by shouldering the responsibility for designing, constructing, financing, and operating the assets in order to deliver the services demanded by the public sector (Ahadzi & Bowles, 2001). It is claimed that on average, privately financed projects deliver savings of 17% compared to public sector alternatives – this represents a saving of £2 billion on a £12 billion programme, equivalent to 25 new hospitals or 130 new schools (HM, 2000).

The examples of private sector participation in provision of services in the UK vary in both arrangement of agreements and type. According to a HM Treasury report (HM, 2000), since May 1997, the UK government has signed contracts for some 150 projects, bringing in capital investment totalling over £12 billion. These include:

- 35 major hospital projects, representing the largest investment in new hospital facilities since the NHS was established;
- Projects covering 520 schools and 4 prisons;
- 25 defence contracts;
- Projects to modernize the Government estate.

According to recently released news, more than 200 projects funded by public private financing are now in operation around the country. Total private investment has risen from £3.5 billion before 1997 to £14.3 billion by May 2002 (Prescott, 2002), and the number of signed deals as of the beginning of April 2003 is reaching £52.71 billion (OGC, 2003).

## **METHODOLOGY AND OUTCOME**

The potential opportunities of private sector involvement in providing services projects in Saudi Arabia depends mainly on the aptitude and capability of the construction Industry participating in this process (Jalaluddin, 2001). The Government, which is the major buyer of such services, is calling for the private sector to participate, and local banks are ready to be involved (Thompson, 2000; Bourland, 2000). In order to test the awareness and aptitude of the construction industry for the implementation of PFI as a new method of procurement, a questionnaire was designed to collect information from contractors working in the Saudi Arabian construction market. The questionnaire consisted of three parts; the first part was aimed at gaining general information about the respondent's

organization. The second part was aimed at checking the level of the respondent's knowledge about PFI, prior to the third part, which was aimed at testing the willingness and aptitude of the construction organisations to bid for PFI projects. The questionnaire was personally distributed and collected by hand in order to avoid the delay usually experienced in postal questionnaires in Saudi Arabia (Al-Turki, 2000), and to try to avoid any unreturned or uncompleted questionnaires. Twenty-five questionnaires were distributed in July 2002 within medium and big construction contracting organisations, and twenty-three questionnaires were collected, the response rate was thus 92%. The term 'Build-Operate-Transfer BOT' was used in the questionnaire to represent the participation of the private sector in the providing services projects; the rationale for doing this was the wide use of this term to describe such procurement systems. PFI and PPP are not used locally either by authorities or businesses. Respondents' organizations main businesses were either contracting, maintenance or contracting and maintenance firms (Fig. 1), ranging in sizes, ages, and numbers of new contracts undertaken every year (Fig. 2, 3, 4)

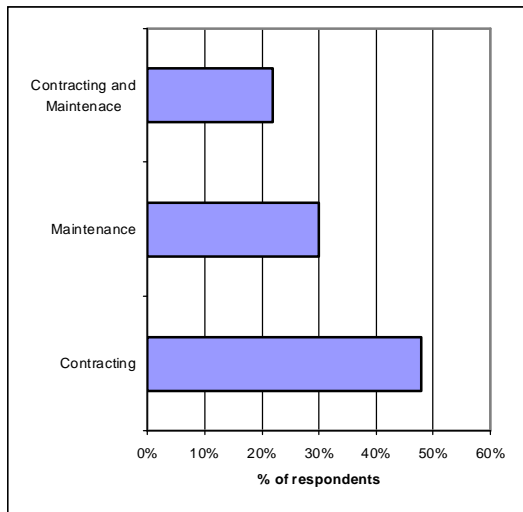


Figure (1) Organization main business

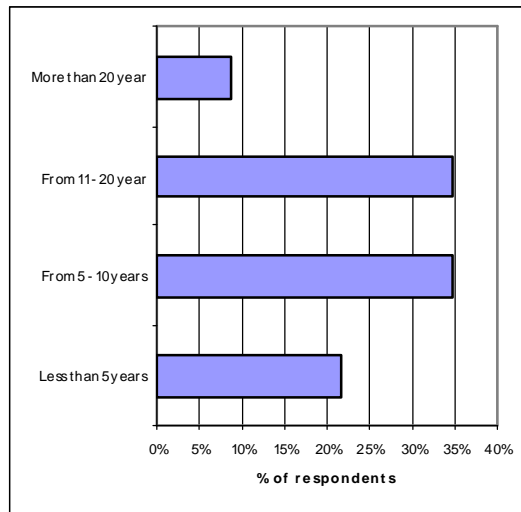


Figure (2) Age of organization

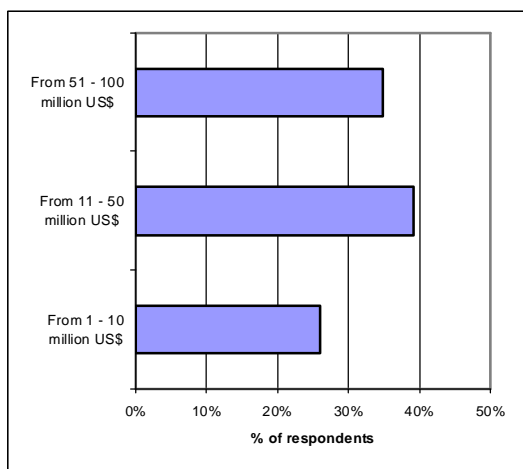


Figure (3) Expected yearly turnover

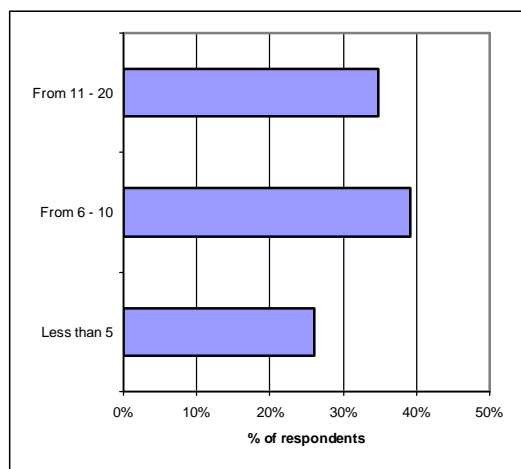


Figure (4) No. of new yearly contracts

Questions aimed at testing the knowledge of the respondents about private sector participation in providing services indicated the formalities of such initiatives, although none of the organisations that responded had at any time undertaken any contract under BOT agreements. Only four out of twenty three knew about contracts completed or in progress in Saudi Arabia using BOT (Fig. 5). All respondents agreed that the role of the government in providing services under BOT agreements was to monitor and follow up and control, not to build and operate. They all thought that quality would increase if the private sector was to participate in providing services projects, and 87% of them thought that the private sector was in a better position to manage and operate public services projects. Figure (6) shows what respondents believed as an effect of BOT and private sector participation on services, and this indicates that the level of awareness was quite acceptable since all answers were consistent with what PFI is aiming to provide.

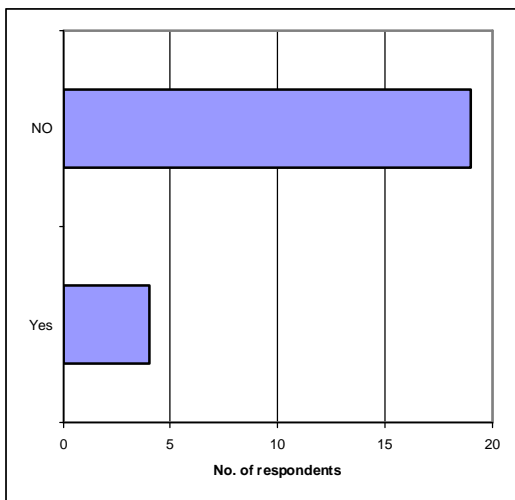


Figure (5) Do you know any contracts done in Saudi Arabia using BOT?

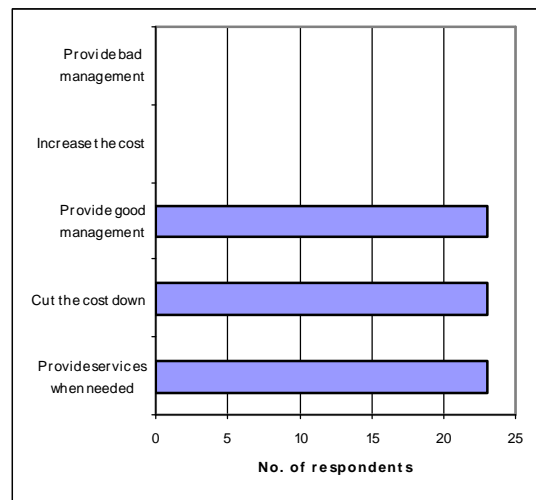


Figure (6) Do you think the participation of private sector in providing services will

As shown in figure (7), 78% of respondents believed that the construction industry was able to finance and manage services projects. In another question, 65% of the respondents had experience of financing their projects from banks or finance authorities. Figure (8) shows that 87% of the contractors responded were ready to bid for BOT projects.

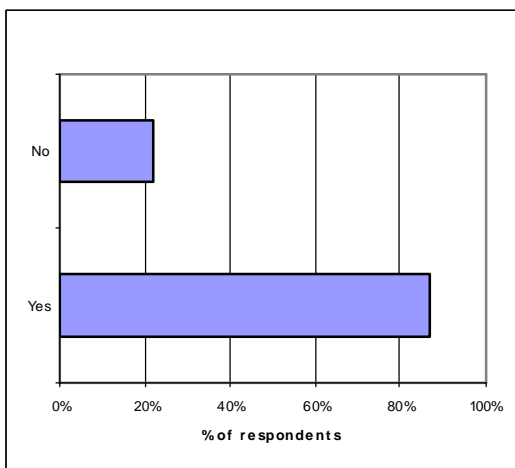


Figure (7) Is construction sector able to finance and manage services projects?

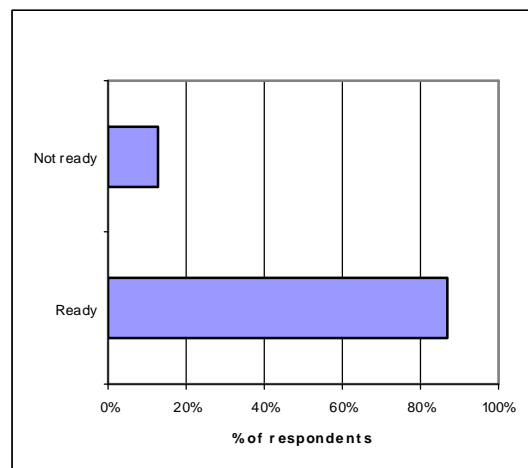


Figure (8) Contractor's readiness to bid for BOT projects.

Analysis of the questionnaire shows that 100% of the respondents thought that banks would help the private sector in financing BOT projects, and 91% thought that contractors could manage services projects in the long term. But 91% were worried that regulations could be a problem the private sector would face in managing facilities for long-term contracts. Problems with regulation may include ones of instability and unpredictability (Figures 9,10,11).

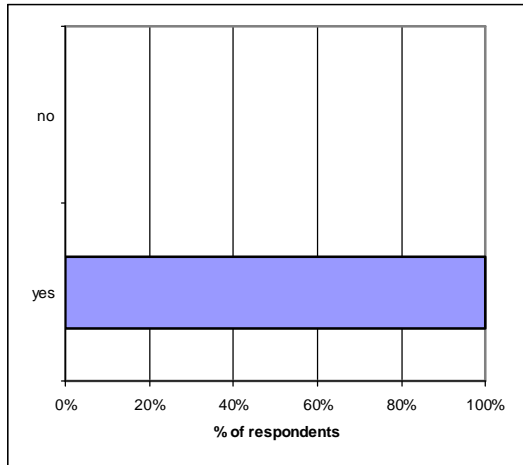


Figure (9) Do you think that banks will help in financing BOT projects?

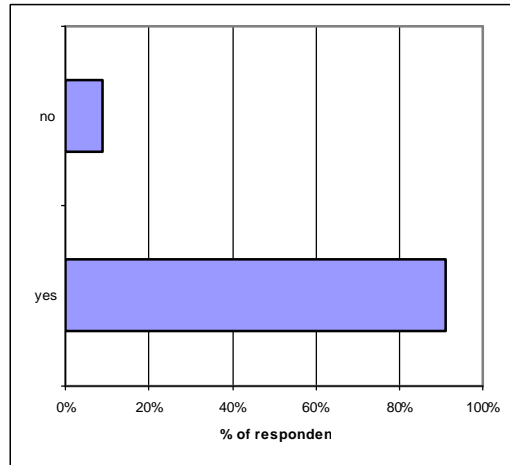


Figure (10) Do you think contractors can manage services projects for long term?

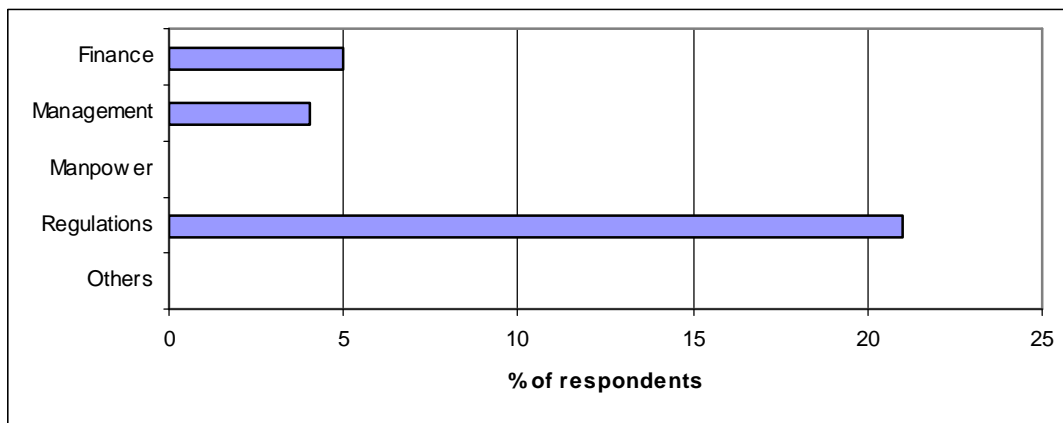


Figure (11) What problems could the private sector face in managing facilities for long term contracts?

## CONCLUSION

The process of successfully implementing initiatives of private sector financing, construction and operating services requires the existence and assurance of many factors. In Saudi Arabia, the capital market is relatively large, the monetary system is stable, the government commitment is strong, and the government movement toward private sector and investors to participate in the development process is encouraging. The experience of local and international banks in funding projects has been successful, and they are willing to participate in future projects, provided they have an assurance of project viability and profitability.

This paper shows that the potentials of PFI/PPP opportunities are clearly identifiable, and that many applications are being announced in infrastructure projects. This project procurement policy will help the government to build the required projects, improve efficiency, hasten availability, release the pressures on the national budget, and help in



controlling the public deficit. Construction organizations have been involved in the Saudi Arabian infrastructure projects for long time, and this study shows the positive aptitude in the participation and involvement in services projects provided for under the Private Finance Initiative.

In addition, the nature of accounting for PFI contracts requires payments that depend on the availability and quality of the required service, this means no debt will be recorded on the government accounting system since the services should be guaranteed first. By saving the initial capital cost which formerly paid in traditional construction procurements, and by paying for these services later in instalments based on the fact that the services are delivered according to contract's conditions, the government will maintain or reduce the level of budget deficit as well as benefit from other operational advantages.

It is recommended that Government encouragement of public-private partnership be coupled with the establishment of regulatory and legal institutes and frameworks, which will pave the way for fair and professional implementation of such complex policies, and which is essential in providing the awareness, guidance and knowledge required for all levels of management. These institutes will also help in the preparation and development of PFI projects.

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