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PPPs – In pursuit of fair risk sharing and value for the people?

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1. Defining the term PPP is the first, but not easy step in engaging discussion on Public-Private Partnerships. For the European Commission, PPPs involve "*all forms of co-operation* between public authorities and business in funding, construction, renovation, management and maintenance of an infrastructure or the provision of a service". The European Investment Bank refers to "a *wide variety* of working arrangements from loose, informal and strategic partnerships, to design build- finance-and-operate type service contracts and formal joint venture companies." For the IMF, they are seen as explicit alternatives to privatisation: "arrangements where the private sector supplies infrastructure assets and services *that traditionally have been provided by the government*". The OECD definition does not depart from the above although it is slightly more explicit on the contractual and for-profit nature of PPPs and the risk transfers that are supposed to take place. In the OECD view, PPPs are contractual agreements between "the government and one or more private partners (which may include the operators and the financers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are *aligned with the profit objectives* of the private partners and where the effectiveness of the alignment depends on a *sufficient transfer of risk to the private partners*".

2. In practice there are many different arrangements that fall under the generic 'PPP' acronym. The most common arrangement is the above-mentioned "Design, Build, Finance, and Operate" (DBFO). As such, PPPs are placed mid-way between traditional public procurements and concessions (and beyond that full privatisation). Unlike public procurements, PPPs go beyond the purchase by the government of an asset produced by a private operator. Rather, the government buys a "stream of services that the private partner generates with the asset" and which ownership and responsibility for maintenance remain with the private operator (OECD 2008). Furthermore PPPs are ruled by private contract law, with weaker transparency and disclosure requirements than under not public administration

law. Compared with private concessions, it is argued that there is a lower level of transfer of risks from government to the private operator, particularly with regard to demand (or commercial) risks. In addition, under a PPP scheme revenues of the private operator can come from both user charges and direct payment transfers from government, while under a concession user charges are the only source of revenue (and when direct payments are made it is the other way round: the private operator pays a fee to the government for the right to operate the concession).

The rationale for PPPs and "Value For Money"

3. The decision to choose the PPP option over public procurement should be ruled by the principle of "Value For Money" (VFM) according to which PPP should be selected only if it delivers better VFM than the public option. In theory such comparative exercise takes the form of a 'public sector comparator' or a full cost benefit analysis. However there is uncertainty however about the criteria for defining VFM. For the OECD, governments should apply the VFM process in three steps:

- They should first assess the budgetary *affordability* of the PPP solution as compared with public procurement alternatives and, from there
- its level of *efficiency* in delivering the services. Efficiency ultimately will rest upon
- the amount and nature of the *transfer of risk* from government to the private sector operator and finally
- the degree of *competition* prior and after the award of the contract.

Affordability

4. The discussion on affordability is central to the VFM principle. The reality is somewhat different. Affordability as defined by the OECD is about "whether or not a project falls within the intertemporal [i.e. multi-annual] budget constraint of government". If the current value of a project – including the future benefits and revenues – remains within the limits of existing government debt, then the project should be considered as affordable. In practice however, the OECD notes that such assessment is "never made" because governments do not think in terms of multi-annual budgeting exercises but in annual exercises. Accordingly governments "use the rule of thumb" – says the OECD – that a project is affordable if its costs fit within the remit of current budget capacities. It is then no surprise that the PPP option often will compare advantageously because it implies a reduction of government capital expenditure in the current annual budgeting exercise. As noted by David Hall a "key assertion is that PPPs are better because somehow they do not cost the public, or the public sector, anything" […] and "that the government or municipality will have more money left to spend on other services". In the long term however, the future stream of payments from government to the private operator need to be accounted for. When that is done, what will make the difference between the PPP and the public procurement options is (i) the interest expenditures (that is the cost of financing) and (ii) the relative levels of efficiency achieved in the two cases. Because the cost of financing always will be higher for the private sector than for government, the affordability criteria of a PPP option ultimately rests on the relative efficiency gains. They should be large enough not only to exceed the efficiency of the public option but also to compensate for the higher cost of financing that is inherent to the private option.

Efficiency and risk transfer

5. While cost of financing is easy to measure and quantify objectively, determining the level of efficiency is a much more complicated task. According to the OECD, the PPP option should prove to have superior "technical efficiency" (*i.e.* minimum inputs and maximum outputs) and "X-efficiency" (*i.e.* preventing the wasteful use of inputs). Efficiency gains are achieved by "sufficient risk transfer" to the private operator based on a proper allocation of the risks to the party (public or private) that is "best able to manage" that risk.

6. Project risks can be divided in (i) commercial risk and (ii) regulatory and political risks. In a PPP framework it is assumed that the private sector will be best able to take on commercial risks, leaving political risk to the government. Commercial risks can be sub-divided into supply risks (project costs) and demand risks (project revenues). Supply risks include all production-related risks: building, production processes, technology change and, not least, labour. Demand risk relates to the revenues generated by the project (changes in consumer choices and behaviour, in competition level) as well as macro-economic risks (growth, demographics, changes in interest rates, in exchange rates and price inflation).

7. Supply risks usually will be allocated to the private operator. PPPs will hence involve a transfer from government to the private operator of the social risk – wages, occupational health and safety, if not pensions. In theory demand risks too will be considered to be best managed by private parties. But that is not always the case: during the contractual negotiations the private operator often will negotiate as many caveats as possible to limit its exposure to volatility in revenues (and in other demand risk) – the main attraction of the PPP for businesses precisely being the predictable and constant generation of revenues. The discussion on the allocation of risks under PPP can also be framed in terms of 'downside risks' (the probability of losses) and 'upside' (the probability of realising gains and profits, such as accessing capital gains on the sale of PPP assets). While downside risks indeed may be shared between the public and private parties, for some PPP contracts the 'upside risks' are left with the private sector only.

Pricing and assessing risks

8. Under a PPP framework, the allocation of risks is based on the notion of the party that is "best able to manage the risk". For the OECD it is not always straightforward what is actually meant by being "best able to manage risk". It can be the party that has the largest influence to prevent the risk from occurring, or it can be the party that can best deal with the consequences after occurrence of the risk. David Hall argues that according to recent research, government remains the party that handles demand risk in a most efficient, not the private sector. Furthermore allocation and transfer of risks depend on the ability to price risk appropriately – what the OECD and others call "risk profiling". This is a particularly difficult exercise to proceed with in the case of large complex projects involving different forms of financing, of activities and services as PPPs often do. Overall the OECD lists several factors making risk pricing difficult:

— *The inherent complexity of the PPP financing* – the use of special purpose vehicles, debt financings with different maturity and risk exposure, securitisation – and the extremely long period of financing (from a private sector point of view);

— *The distinction between legal ownership (i.e. in private hands) and economic ownership (shared by the government)* do not "accurately reflect the actual risk-sharing arrangement". The private operator indeed can claim legal ownership of the project's assets (as set by contract), but if demand risks are retained by government, this ownership is rather illusionary from an economic point of view;

— *Risk pricing of public services* – in health, education, security for example – is problematic. For such services, the occurrence of the risk is simply not an option for the government (for example electricity breakdown in a hospital, education below minimum standards, etc) and hence standard risk pricing methodology is not valid. In fact forced risk pricing of a public service may lead to distorted objectives. In education for example, EI reports that PPP schools may target different objectives than those in the public sector by moving from "child-centred" to "economy-centred" approach to education.

Competition

9. The existence of a fairly strong level of competition in the private sector is also key to ensure efficiency of the PPP option. This is true both for the pre-contract phase (the tender process) and for the post-contract phase (management of the project). In the pre-contract phase, it will be difficult for government to obtain VFM if there is no real competition, or potential entry, in the tender process. After the signing of the contract, contract re-negotiations are frequent. When that happens, the OECD notes that, being a "monopolistic supplier", the private operator "has an advantage" in negotiating with the government "compared to a supplier in a competitive market". More broadly, the fact that PPPs are long-term contracts (20-25 years, as compared with 2-3 years for public procurement projects in infrastructure) does not contribute to healthy competition markets. Quite to the contrary, the private group that wins the bid will secure such a comparative advantage (in terms of expertise and know-how) that it will be able to crowd out any potential competition in the future.

Governance and management of PPPs

Legal status and financial engineering

10. In terms of governance and transparency, the PPP contract offers a different legal framework than the public procurement option, in so far as it is ruled by commercial and competition laws, which confidentiality clauses will be more demanding than those prevailing under public administration. Furthermore, the financial engineering of the PPPs will make them strikingly similar to those found under a leveraged buy-out private equity regime. Behind the term "private operator" of a PPP, there is often a web of holdings, of "special purpose vehicle" (SPV) and "special investment vehicle" (SIV) which are set up by the private sector contractors (which perform the services) and their banks to optimise financial engineering of the project. PPPs also can be arranged around a joint venture company partly owned by the government. Just like LBOs debt financing is structured in different layers of maturity and risks and is securitised on the global financial markets by the banks participating in the PPP structure. In general the debt structure includes a substantial proportion of short-term papers with variable interest rates and/or which are denominated in a foreign currency

(typically the Euro). This short term debt is rolled over again and again to refinance the project during it entire life. The system is attractive because it helps lower cost of financing – at least at the beginning of the PPP – but just like LBOs it is abnormally exposed to market downturns and volatility as it happened in 2007-2008.

Change in labour contracts and conditions

11. When a PPP replaces a publicly-run service or when it is chosen against a public option, it is assimilated to a transfer of employer and hence bears important labour issues. Several trade union organisations, including PSI, EI, the TUC and UNISON, report a degrading of wage and working conditions as well as evidence of anti-union behaviour following a PPP transaction. Because PPPs bears the risk of a negative impact on workers' rights and conditions, there is an implicit transfer of social risk from government onto workers. Such transfer is rarely taken into account by governments and international organisations.

Complexity of contracts

12. As argued by David Hall, "PPP contracts, like other contracts, are imperfect (or 'incomplete'). They cannot cover all the unknown circumstances and possible problems with delivery of service". This is of particular concern for PPPs given their life span and the complexity and opacity of its financing. The intense negotiations and re-negotiations of contracts that place during the life of the PPP lead to unintended consequences in terms of legal and administrative burden and cost for government, to say the least. The OECD notes that the "excessive time overruns in the pre-contract stages which in turn result in large advisory cost overruns" usually are not taken into account in assessing the overall of projects. David Hall reports that "the claims of PPPs are vigorously pursued by corporate lawyers. […] The transaction costs and risks of contract disputes are a further problem". The British healthcare sector is emblematic in this regard: "the development of quasi-markets has already led to a contractual culture..... the health sector is becoming increasingly more of a playground for lawyers and legal firms". According to Hall "the total transaction costs for PPP projects could average over 20% of the total project value".

Loss of government skills and budget rigidity

13. The complexity of PPP contracts may undermine government administration's skills and capacities. Under a PPP regime, the public administration in charge of the negotiations "does not possess the same information as the private operator", says the OECD, and hence it "is at a disadvantage if aspects of the PPP contract are renegotiated after the conclusion of the contract". In fact, the public administration "might not fully comprehend the precise reason why value for money is not achieved"… The lack of skills and negotiation capacities by government authorities is made worse when its key personnel participating in a pre-contract PPP negotiation opportunistically decide to change side and work for the private operator.

14. Finally, PPP contracts may aggravate budget policy "rigidity". Because of their long spanning periods and legalistic contractual constraints, PPPs can be very inflexible instruments for government. As noted by the OECD "since the design, standards and forecast demands may prove inadequate or irrelevant to shifting societal needs, the inflexibility and the long-term nature of PPP contracts are major weaknesses". For David Hall, budget rigidity "in turn means that reductions in spending are concentrated on non-PPP areas", creating inefficient, if not unfair, budget allocation policies.

Other issues

The recovery policies and the stimulus packages

15. A key attraction of PPPs for business is the secured and long lasting source of revenues that they generate. David Hall argues that the current global crisis "provides private companies with even greater incentives to sign PPP contracts, in order to get long-term business from the government at a time when demand from the private sector is falling". Several governments have placed PPPs among the main beneficiaries of their stimulus packages The relaxed conditions offered by some governments such as France – extending state-guarantees up to 80% of PPP's debt financing – raises the question of whether PPPs have become proxies for direct subsidisation of private businesses.

Developing countries

16. Much, if not all the above, is taking the view from an OECD country perspective, where public infrastructure and public services have a history. PPPs are developing rapidly in non-OECD countries however, both in emerging economies (prisons in South Africa for example, transport infrastructure & water in Brazil) and in developing countries particularly in South-East Asia. They have become a key instrument of the new OECD-endorsed blueprint for attracting foreign investment: the Policy Framework for Investment (PFI).

17. A survey conducted by the EI shows that trade unions from developing countries stand in contrast with their OECD-based counterparts in so far as they have a much less negative perspective on PPPs – and quiet often are pretty supportive of it. A tentative explanation could be that, unlike in OECD countries, PPPs in developing countries may well take place in situations where there is no credible alternative on the short and medium term (no public option available). They may also involve community-based NGOs and services to a much greater extent than in the OECD, as reported by EI with the development of "multi-stakeholder partnerships in education".

Sources:

This paper was prepared for a TUAC meeting on Public-Private Partnerships (PPP) on 13th April 2010. It aims at identifying the main issues with PPPs and to feed in the meeting's discussions which should consider the next steps for TUAC and affiliates in close cooperation with Global Union Federations, including the PSI and EI, and with the ITUC. It draws extensively on an OECD publication released in 2008 "PPPs – In pursuit of risk sharing and value for money" as well as on recent trade union contributions and analyses from the PSI-RU, EI, EPSU and the CSN.

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