A crisis for public-private partnerships (PPPs)?

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David Hall
d.j.hall@gre.ac.uk

This is the second in a series of notes on the impact of the crisis on public services and the public sector. Further notes will look at government reflation packages, government deficits and debt, specific public services and employees, and companies involved in privatised sectors and government service contracts.

PSIRU, Business School, University of Greenwich, Park Row, London SE10 9LS, U.K.
Website: www.psiru.org *Email:* psiru@psiru.org *Tel*: +44-(0)208-331-9933 *Fax*: +44 (0)208-331-8665
Researchers: Prof. Stephen Thomas, David Hall (Director), Jane Lethbridge, Emanuele Lobina, Vladimir Popov, Violeta Corral
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1. Credit crisis, recession and PPPs

The reflationary packages of governments to counter the recession typically involve increasing public spending and borrowing. Some of these packages include investment in infrastructure – roads, bridges, railways, hospitals, schools, and the like.

Traditionally, governments themselves have borrowed money to pay for the building of infrastructure, and this is still the main way in which it is financed in most countries. In recent year, there has been an increasing tendency for governments to use public private partnerships (PPPs). These involve a private company raising the money for the investment, and then recouping that investment by operating the asset over a long period, and either charging users – a concession-style PPP – or receiving payments from government – a PFI-style PPP. The key attraction to governments of PPPs is that the finance can be counted as 'private' borrowing by the companies, and so does not appear as extra government borrowing; the key attraction for companies is a stream of payments guaranteed by governments for periods of 20 years or more

It might be expected that responding to the recession would increase the demand for PPPs from governments, because they are a way of building infrastructure while limiting the apparent effect on the official government deficit. The recession also 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.

However, the credit crisis means that banks and investors are much more reluctant to lend to private companies at all. As a result, companies are practically unable to borrow money to finance PPPs. There is now clear evidence that very few new PPPs will be signed for the foreseeable future; and that existing PPPs are being affected by inability to refinance their original debt, and lower revenues because of falling demand. This financing problem reinforces other concerns about the impact of PPPs: a recent PSIRU paper contains a detailed discussion of PPPs and issues of cost and performance.[1]

2. Evidence from countries

2.1. General: finance 'dries up'

A global review in December 2008 by PriceWaterhouseCoopers (PWC) estimated that interest rates for lending to infrastructure projects have risen to about 1.5% or 2% above the lowest rates which governments can obtain, and even more in developing countries. In effect:

> "The debt markets have all but dried up…The outlook for the near term remains grim. Few [PPP] deals will close. Many have already been put on ice….Bank debt is simply insufficient, and inefficient, as a source of long term finance….It is a naïve notion to expect the markets to revert to the low pricing obtained in the first half of 2007. Such conditions are unlikely to be seen again". [2]

The recession and the credit crisis also create problems for existing PPPs, for two reasons. Firstly, the recession reduces income on concession-type PPPs, such as toll roads, so that earnings will be lower than forecast, so it may be difficult to repay interest and loans. Secondly, many PPPs raised short-term debts to launch the project, expecting to refinance it with debt at lower interest rates once the project was operational, but will now find it very difficult to get new loans without increasing the cost of interest payments. As a result:

> "They may face the double hit of worse than forecast debt terms and revenues, or even be unable to refinance at all". [3]

2.2. UK

The flow of PPPs in the UK, where PPPs are most established under the Private Finance Initiative (PFI), has slowed down. Only 34 new PFI projects were signed in 2008, the smallest number since 1997.[4] One PPP for an 11-mile stretch of motorway has been signed in January 2009, but this relied heavily on a public sector bank – the European Investment Bank (EIB) - agreeing to provide more than half the finance. Even a financial adviser involved in the deal said that it was 'remarkable' and 'against all the odds in the current financing markets'[5].

Andy Rose, the executive director of the UK's PFI unit, said in November 2008 that PFI projects can no longer rely on their previous method of raising bond finance, and are now dependent on bank loans which are only available at much worse terms:

> "the bond market, which has been the financial structure of choice for large PFI projects over the past 10 years, is now effectively closed to new transactions. This has increased reliance on the banking market…and increased the strain on the project finance banking model…….funding availability is limited and credit margins have moved up… many banks are indicating that the tenor of loans might be shorter." [6]

John Tizard, the director of the new Centre for Public Service Partnerships at Birmingham University, says that this has already halted finance for PFI schemes and may make them unattractive for the foreseeable future:

> "At the time of writing, there is no – or next to no – capital available to finance any PFI deal that has not already been closed." [7]

UK public service programmes which currently rely on PFI/PPPs may suffer, including education, waste management, and health services. [8]

- A report in January 2009 by a parliamentary committee on the schools infrastructure programme for the UK expressed concern that investors "may be far less willing to enter into PFI arrangements in connection with the Building Schools for the Future programme". [9]

- A report from the National Audit Office in January 2009 warned that waste management projects based on PFI/PPPs are already delayed, and face further delays and uncertainty because of "difficulties in the financing markets". Delays in implementing these schemes could lead to costly fines for failure to comply with EU environmental standards.[10] The recession is creating further problems with existing and proposed PPPs in the waste management sector. These PPPs depend partly on revenue from sales of recycled materials, and the recession means that demand for these 'secondary materials' has collapsed. [11]

- According to a leaked memo, health authorities have been told to: "Expect a capital desert in 2010/11. The bad news is around capital schemes that would have been PFIs. PFIs have always been the NHS's 'plan A' for building new hospitals, especially as they used to be off-balance sheet. There was never a 'plan B'. Now none of the banks have any money or are likely to have any for a few years, the absence of a 'plan B' is going to cause a real problem in taking new hospitals to conclusion." [12]

Tizard suggests that the obvious response is to revert to traditional government borrowing, which is in any case cheaper:

> "If the cost of capital and/or debt increases or becomes more difficult to secure, the value for money equations, which are undertaken on PFI deals, may tip over against the use of PFI. …In these circumstances, all other things been equal, it might be appropriate to consider financing through

> models such as the Credit Guarantee Scheme and other forms of funding through government bonds and public finance. Government can borrow more cheaply than the private sector."[13]

2.3. France: PPPs and 'plan de relance'

In France there is an attempt to introduce special provisions to get round the problems with the financial markets, and so use PPPs for much of the infrastructure spending included in the government's economic measures to deal with the crisis (the 'plan de relance').

The plan itself includes a government guarantee for all bank loans taken out by a PPP, and in January 2009, the French senate introduced various amendments which are intended to make PPPs more viable by various forms of government intervention. These include: special tax allowances; allowing the government to advance to a bank the great majority of the loan required by the private partner – thus enabling the bank to pass on the lower interest rates obtainable by government; and allowing PPPs to be signed on the basis of 'adjustable financing', without finalising a deal with banks, so that it can proceed on the basis of government advances while waiting for improved conditions in the financial market. [14]

The scale of government intervention involved in these mechanisms indicates the difficulty of finding finance for PPPs in the credit squeeze.

The private companies have also argued for further changes to make it easier to introduce PPPs. The president of Vinci, a major construction company, argued earlier in January 2009 for a greater use of PPPs to ease the pressure on government debt, and a relaxation of the law so that the companies themselves can propose projects.[15]

2.4. Spain: PPPs impact on public sector credit ratings

PPPs involve 20-30 year contracts which commit governments and other public authorities to payments over a long period, thus reducing the flexibility of governments in future public spending decisions. A recent credit rating report from Standard and Poor's warns that these inflexible commitments can damage a public authority's own credit rating – or its level of spending on public services. [16]

The report concerns the Autonomous Community of Madrid, which retains a high rating of AA+ reflecting the relative wealth of the region. But S&P give a 'negative outlook ' , partly because the recession may affect tax revenues, but also because of the region's "inflexible expenditure base", partly due to its concentration on social spending, but partly due to:

> "the acceleration of investments through public-private partnerships (PPPs). PPP investments generally increase ACM's financial commitments and, consequently, Standard & Poor's includes them as tax-supported debt."

According to S&P, servicing debt will account for between 60% and 75% of ACM's spending in 2010. Because the recession will lead to possible decline in revenues, ACM is expected to make corresponding reductions in its operating costs, but:

> "Low expenditure flexibility and increasing budgetary rigidity deriving from large PPP programs may hinder ACM's capacity to curb its operating costs in the long run."

This inflexible burden of PPP debt means that ACM's "expenditure reduction measures" will have to be made by reducing employment and services in ACM's budget. Otherwise, ACM's credit rating will be revised downwards – further increasing the cost of its own debts.

2.5. Australia and New Zealand

Australia has made considerable use of PPPs, especially for road schemes, but a number of projects have not delivered results and the credit squeeze threatens the future. In January 2009 an article in The Australian summarised the position:

> "The brutal reality is that most private sector toll operators are a shambles. Most have overinflated their traffic forecasts, financed them with a slice of equity from the public markets, then geared up, and paid investors back their own capital in distributions (which enticed them into the float in the first place). As the debt markets worsen and most listed infrastructure funds have fallen apart, a new model is needed to help finance the estimated $800 billion the country needs to spend on infrastructure in the next decade….. The Infrastructure Partnerships Australia chairman Mark Birrell said that: "Otherwise, we could find that projects simply won't attract a suitable level of interest in the much-changed global economy," he said." [17]

Construction companies themselves are pointing out the advantages of the traditional model, whereby the government borrows money itself and then invites tenders for simple construction contracts, rather than attempting to construct PPPs in the context of the credit crisis. Mark Binns, the chief executive of a major Australian contractor, Fletcher Construction [18], told an enquiry in New Zealand:

> "If the aim was to bring projects to fruition quickly, making them PPPs would be a retrograde step, as so much time is involved in setting up the legal framework between participants in the project, he said. He also questioned whether private sector funding would be viable in the current credit environment without Government guarantees, which nullified the transfer of risk to the private sector…..Sometimes the benefits of transferring the risk of PPP projects to the private sector were illusory, it said, citing the British Government's bailout of Metronet, the private operator of the London Underground…. if the transfer of risk was not complete, the true benefits of PPPs came down to an analysis of the funding costs, and there was a strong argument that the Government would be better off just raising debt, potentially through infrastructure bonds, to do the project using other traditional methods of contracting."

2.6. USA

In the USA, PPPs have not been widely used so far. Some toll roads have been privatised under concession-style PPPs, but there has been controversy over these schemes.[19] In Texas, a proposed $183 billion roads PPP was cancelled after widespread protests, and a report by the Texas legislature was divided over their value.[20] There is evidence of the credit crisis as well: the publicly owned port of Portland abandoned plans to sell a lease for a private container terminal, citing difficult market conditions.[21]

Some companies are hoping that PPPs will be used for at least part of the large infrastructure spending programme announced by president Obama, but it remains unclear whether this will happen.

2.7. Problems elsewhere: Ireland, Slovakia, Canada, Russia

In other countries there is also evidence that PPPs are being cancelled because of the credit crisis. The recession is also having an effect because of declining payments for toll roads, for example.

In Ireland, six social housing PPP projects have been cancelled; a planned prison PPP was cancelled indefinitely in January 2009 because of 'problems with the credit crunch', and a PPP for a metro in Dublin is now in doubt. [22]

Slovakia's programme of road PPPs is in doubt, with the prime minister Robert Fico saying that "I am concerned the banks will not want to take part at all".[23] The government is now preparing an alternative: "The Transport Ministry has prepared an alternative plan for highway construction in Slovakia, financed directly from state coffers, in case of a failure of three public-private partnership (PPP) projects which are currently being tendered". [24]

In Canada, the Ontario auditor general has criticised the first hospital PPP in the province and stated that it would have been $50m. cheaper if it had been built by the provincial government without a private partner. [25]

In Russia, the government response to the recession may itself have a negative effect on PPPs, because public spending is being constrained rather than increased. According to Andrey Zverev, head of the Russian government's analytical centre, the recession is leading to a fall in tax revenues, and there is a serious risk of regional authorities defaulting (S&P in December rated the Moscow regional oblast as 'selective default'[26]): to avoid this, cutbacks in state spending will be required, and this includes cutbacks in PPPs:

> "the state is most likely to cut its investment in Public Private Partnership (PPP) projects."[27]

A review of the prospects for the construction industry in Russia gives a similar pessimistic assessment. It says that the recession and credit crisis will:

> "lead to investors tightening their belts, leaving less money to go towards funding infrastructure related projects, especially those in the real estate sphere. This could see a serious decline in the number of companies available to participate in Private Public Partnership (PPP) projects, which will lead to delays and in some case cancellations of proposed infrastructure schemes."[28]

In India, the government is trying to avoid a shortage of funds from the private financial sector by allowing a state-owned financial body, the India Infrastructure Company Limited (IIFCL), to raise $6 billion worth of tax-free bonds, to help fund projects worth $15 billion.[29] It is not clear that this fund will be used exclusively for PPPs.

3. World Bank and IFC

PPPs have been widely promoted in developing countries for many years by the World Bank and other donors and development banks, although it is now generally acknowledged that they have failed to deliver investments.[30]

The IFC, the private sector financing arm of the World Bank, believes that the credit squeeze will make it even harder to finance PPPs. It estimates that $110 billion worth of proposed PPPs may be delayed or cancelled, and that $70 billion of existing PPPs are at risk because of increased costs of financing these projects for the private sector.[31]

The IFC also states that private investors are less interested in infrastructure in developing countries: "Hedge funds are rapidly scaling back their investments and private equity funds are hoarding capital; Asian and Middle Eastern sovereign wealth funds may divert more of their portfolios to their regions; investors are demanding higher returns for a given level of risk; poorer developing countries are being crowded out as private investors are focusing on the largest emerging markets."[32]

The IFC itself has created a global "equity fund" and a "loan financing trust" to support PPPs or purely private infrastructure projects. The IFC is contributing $300 billion of public sector money to this equity fund, and expects 'others' to contribute between $1.2 billion and $10 billion. These 'others' are probably intended to be donor countries or agencies, contributing more public sector aid and finance, to sustain private sector infrastructure projects. Locking up aid in this way would prevent it being used to finance other services.

4. Comments

The simple alternative is the traditional method of financing public infrastructure - through government borrowing to raise finance, issuing construction contracts, and then operating the facility, whether through direct labour or contractors.

This remains perfectly feasible. Governments are still able to borrow the necessary money: their credit is not affected in the same way as private companies. Traditional procurement is also simpler and quicker than PPPs: attempts to maintain PPPs as a core method of funding risk delaying infrastructure projects. The desired level of infrastructure investment can thus be achieved without any use of PPPs at all.

A recent PSIRU paper contains a detailed discussion of the choice between traditional procurement and PPPs. [33]

5. Notes

1 Public-Private Partnerships (PPPs) in the EU - a critical appraisal PSIRU November 2008 http://www.psiru.org/reports/2008-11-PPPs-crit.doc
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[14] Le secteur privé sollicité pour accélérer les grands travaux. Les Echos 22 janvier 2009
["….Premier sujet : les cessions de créances. L'idée est de porter de 80 % à 90 % la part des coûts d'investissement que l'opérateur privé - une entreprise de BTP le plus souvent - peut céder à son banquier partenaire, lequel peut ensuite proposer des taux d'intérêt moins élevés dans la mesure où il se fait rembourser directement par la personne publique. Philippe Marini, en accord avec le gouvernement, veut, quant à lui, modifier l'esprit même des PPP, en permettant que l'entreprise privée n'assure plus qu'une partie du financement. *« Cela permettra de réduire le coût des projets, lorsque les conditions de financement des collectivités sont plus intéressantes qu'un financement bancaire intégral »,* défend le rapporteur du budget. La participation des collectivités locales sera cependant limitée à un tiers du financement, afin que le partenariat ne devienne pas public-public. Deuxième sujet : la fiscalité des PPP. Les sénateurs veulent rendre ces contrats *« plus intéressants pour le partenaire privé et moins coûteux pour la collectivité contractante »,* en jouant sur la TVA et la taxe professionnelle, et en créant une avance remboursable afin de rémunérer les candidats évincés. Troisième sujet : la passation du marché. En 2009 et 2010, l'administration pourrait être autorisée à attribuer un PPP à un candidat *« dont l'offre finale présenterait des modalités de financement ajustables ».* Dans l'esprit du législateur, il s'agit d'échapper à l'instabilité des marchés financiers, en lançant des chantiers, même en l'absence de bouclage financier définitif. Une mesure clef, qui a l'appui du gouvernement…
Dans son plan de relance en cours d'examen au Parlement, le gouvernement a décidé d'apporter la garantie de l'Etat aux prêts bancaires accordés au signataire d'un PPP, pour une enveloppe maximale de 10 milliards d'euros et moyennant une rémunération comprise entre 0,2 % et 0,5 %, selon le niveau de solvabilité du bénéficiaire. Par ailleurs, le Sénat souhaite permettre aux opérateurs des réseaux d'énergie, d'eau ou de transports de signer des PPP selon une procédure dite « négociée ».".]
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