

PUBLIC PRIVATE PARTNERSHIPS IN TIMES OF ECONOMIC AUSTERITY

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It often takes looking to the past to look to provide perspective for the future. During the financial crises of the 1980s an answer to delivering major transport projects was provided through the adoption of Public Private Partnerships (PPP). However since that period the political and financial landscape has evolved. Public spending is shrinking, private sector willingness to accept risk is diminishing and forecasts remain glum.

PPPs would appear to be the ideal solution for cash strapped governments. In theory they allow private capital to fund much needed transport schemes or private companies constructing and operating new infrastructure. The schemes are not hindered by the Treasury's balance sheets, nor dependent on short-term imperatives of public finances and consideration of public debt. However they are often plagued by scheme complexity, political risk and major funding requirements, particularly when considering public transport schemes.

This paper aims to examine the role of PPPs within today's climate of economic austerity. It is divided into three parts: (1) an introduction and literature review of PPP guidance (2) examination of the advantages and disadvantages that PPPs play in delivering major transport infrastructure and (3) interrogation political, project and financial risk in a time of economic austerity and to assess whether PPPs are an optimal choice and surrounding implications.

What is a Public Private Partnership?

A PPP is a relationship between public and private entities that are responsible for the delivery of an infrastructure asset and/or associated services (servicing, operations, and maintenance). Through this relationship there is a transfer of risk from the public to the private sector. Generally, there is a payment mechanism between the public and private sector based on revenue from services and usually ownership is then transferred to the public sector at the end of the contract.

One of the first transport PPPs was Hong Kong's Cross Harbour Tunnel in 1972. The government lacked confidence to ensure scheme delivery and contracted with a private partner. By 1977 the scheme had repaid its debt and led to future PPPs being developed¹. This included one of the first PPP schemes in the UK, the Queen Elizabeth II Bridge which opened in 1991, following Parliamentary authorisation in 1988. Funding was provided through debt finance with stakeholder concessionaires providing £1,000 as equity of the £200million project price tag².

¹ Mal, CK and Mo S. "Some aspects of PPP approach to transport infrastructure development in Hong Kong." Highways Department, Government of the Hong Kong Special Administrative Region

² Richards, Martin. 2009. "Principles Underlying PFI Schemes". Public Administration International.

PPPs continued to gain momentum into the mid-1990s with a series of design, build, finance and operate schemes (DBFO) as more projects were delivered on budget and on time than through traditional procurement. The number of PPPs grew rapidly under Labour's 'third way' approach, as the funding was considered "off the balance sheet" enabling the government to invest without liabilities and limitations. PPPs now account for between 10 to 13.5% of public services, with nearly 22 billion being invested in private capital in the UK PPP sector³.

Following the influx of PPP schemes that successfully delivered projects in the UK, the success of PPPs ultimately unraveled with the London Underground (LUL) in the period leading up to 2008. This scheme brought to light the complexity that can result from PPPs and failed due to lack of scrutiny, financing and funding and confusion over devolution⁴.

This raises the question if PPPs are appropriate for the current climate given the high level of political, project and financial risk in times of economic austerity.

Literature Review

A number of government agencies and organisations have prepared guidance that sets out lessons and best practice in the application of PPPs. These include a range of international policy organisations and UK guidance. This section summarises the over arching themes across:

- The World Bank⁵
- HM Treasury⁶
- Institute for Public Policy Research⁷
- Partnerships UK⁸
- Commission of the European Communities⁹
- United Nations¹⁰

³ N J Smith. 2008. "Political risk in light rail transit PPP projects." Institute of Civil Engineers.

⁴ Allport, Roger; Richard Brown; Stephen Glaister; Tony Travers. 2008. "Success and failure in urban transport infrastructure projects."

⁵ The World Bank. 2010. WBI Learning Programs>Public Private Partnerships in Infrastructure> PPI Portal

⁶ HM Treasury. 2004 "Value for Money Assessment Guidance"; HM Treasury, 2003. "The Green Book"

⁷ Institute for Public Policy Research. 2010. <http://www.ippr.org/research/themes/project.asp?id=962&tID=97&pID=962>

⁸ Partnerships UK. 2010. <http://www.partnershipsuk.org.uk/>

⁹ Commission of the European Communities. 2004. "Green Paper on Public-Private Partnerships and Community Law on Public Contracts"

¹⁰ United Nations. 2008. "Guidebook on promoting good governance in public-private partnerships".

Political Factors

Political factors provide a significant role in the way PPPs are prioritised, funded and delivered. As such it is important to consider the political environment that a PPP is to be established.

World Bank

- For successful PPPs, strong public sector capabilities are required
- Governments should learn as their PPP programmes develop and make adjustments as necessary
- Widespread public opposition to a PPP project can lead to public dissatisfaction and can prematurely end a concession

Institute for Public Policy Research (UK)

- Public authorities need to have a clear policy planning framework which integrates all forms of investment and service provision.
- PFI projects should not go ahead because a public authority believes there is no alternative

Partnerships UK

- Market sounding and shaping is critical

The United Nations

- Public participation and support provides a substantial benefit to delivering PPPs
- Alternatives should be assessed and evaluated and considered within the political domain

Project Factors

It is important to consider the planning and procurement process for the project, this considers project complexity and project arrangements.

World Bank

- Good PPPs need transparent and competitive procurement
- Good PPPs require robust monitoring and flexibility such that they can respond to/accommodate unpredicted events;
- 'Mega-projects' should be avoided at the onset – to test the market and reduce the risk to the private sector

HM Treasury

- The public sector should defines its service needs to ensure that they can be adequately contracted for in a way that ensures effective, equitable, and accountable delivery of public services into the long term, and where risk allocation between public and private sectors can be clearly made and enforced

- Long term planning horizons should be considered with confidence that the assets and services provided are intended to be used over long periods into the future

Institute for Public Policy Research (UK)

- Governments should experiment with a range of procurement models for capital projects.

Partnerships UK

- Programmes of investment are better than one-off deals
- Construction alone shouldn't be the focus, operational phases of the projects should be considered

Commission of the European Communities

- A competitive and transparent dialogue should surround the project arrangements that is well adaptive, while at the same time safeguards the rights of operators

The United Nations

- PPPs policy should begin by fixing clear economic objectives with strong social objectives, that are linked to core values and principles
- PPPs should incorporate the possibility of change
- It is crucial to identify PPPs with realistic targets
- Flexibility is essential in risk allocation

Financial Factors

Financial sustainability is crucial to the scheme, both for the public and private sector. This includes the inception phases of the scheme to the delivery.

World Bank

- Attracting international firms brings finance, credibility and know-how
- The financial profitability and sustainability of PPPs is dependent on the promoter's respect of its contractual obligations
- Most PPP failures are a result of unrealistic revenue and cost estimations, and lack of thorough financial and economic analysis

HM Treasury

- The nature of the assets and services should be identified as part of the PPP scheme, in addition the associated risks are capable of being costed on a whole-of-life and long term basis

- If private sector has the expertise to deliver, there is good reason to think it will offer good-value-for-money and robust performance incentives can be put in place
- PPPs are not recommended if the primary purpose is to remove projects from the Government's balance sheet.

Institute for Public Policy Research (UK)

- The framework for public finances should be revised so that privately financed public investment is taken into account in deciding the sustainability of public finances
- Government departments should be set an overall capital spending budget that encompasses both traditionally financed public spending and the capital value of PPP spending
- The accounting treatment of a PPP should be settled after a decision to go ahead on value-for-money grounds has been made
- All PPP proposals need to be subjected to a sensitivity analysis to see whether different assumption, for example, about different forms of risk allocation, would significantly alter the value-for-money assessment.
- All contracts should have explicit provisions for sharing super-profits arising from re-financing deals

Advantages and Disadvantages of PPPs

To guide assessing the merits of investing in PPPs in the future, a review of the advantages of disadvantages of PPP schemes is summarized below. PPPs can offer advantages for both the public and private entities. This enables the successful implementation of projects otherwise outside the capability of either the public or the private sector. However depending on the arrangement PPPs can face disadvantages that can significantly impact project delivery. This is best summarized in a comment from the *Financial Times* in an evaluation of UK PPP activity, "if everyone was making money, it would mean that the contracts were too easy. If everyone was losing, there would be no interest."¹¹

Advantages:

Commercial and operational efficiency – by conventional wisdom the private sector will use project resources more efficiently than their public sector counterparts. The private sector will be more focused on the "bottom-line" costs and will ensure that the potential for waste in terms of time, materials and Labour will be kept to a minimum.

¹¹ Financial Times. 2006. "Uncertain destination: will private finance for public projects soon run out of road?" *Financial Times*. .

Cost control and locked-in maintenance regime - given the private sector focus on efficiency and control of resources in a PPP, a PPP concession can usually result in incurring lower capital costs than public sector alternatives. Studies in the UK over a range of PPP arrangements show that the cost savings in capital costs have usually been 10-15% lower than the equivalent public sector capital costs.

One of the reasons for the saving is not just the difference in construction and operation cost control of the private sector versus public-sector, but that there is often the recognition in the public sector that the long-term maintenance of public sector service assets is unreliable. As a result, public sector projects may be over-engineered to allow of the possibility of poor maintenance of the project life-cycle, which in turn increases capital costs. The private sector PPP on the other hand will help build an asset 'fit for purpose' supported by a strict and regular maintenance regime which will be adhered to as part of necessary "hand back" arrangements.

Use of private capital – the employment of a PPP as a procurement mechanism introduces private capital to public service provision. Along with that comes many other associated private sector benefits as this section discusses.

Introduces competition –undertaking the delivery of a public service as a PPP, rather than through a Government or Government agency, will of itself traditionally increase competition, particularly if some form of bidding process for the underlying PPP service takes place. Such a bidding process creates a competitive scenario with its inherent benefits for cost efficiency and delivery effectiveness.

Innovation – private sector PPP concessionaries will use the latest, but tested best practices for undertaking their project. Confident in their ability to manage and maintain the PPP project assets, they will build 'fit for purpose'. The private sector also seeks to reduce inefficiencies in the key cost areas.

Disadvantages

Timetable – one of the disadvantages of the PPP type structure is that they are inherently complex. As the PPP financiers rely on the cash-flows generated by the PPP as the security or assurance for returns, respectively, such projects will be surrounded by a collection of contractual relationships minimizing the risks (to cash-flows) during the construction and operating phases. Such financiers, therefore, will take time to undertake their due diligence or checking of such arrangements and therefore implementing PPPs can take twice as long as for conventional funding.

In the event, that the PPP is providing a service to a market, such as a toll-road or public transport scheme, and investors and lenders are assuming traffic risk, undertake the PPP implementation timetable may be longer still. Financiers will wish to undertake in-depth market forecasts before committing their funds.

Up-front costs – the up-front costs incurred for advisors, expert consultants and lawyers will also be higher for PPP type deals than for conventional funding. Typically costs may be at least double, albeit that on occasion such costs may be capitalised into the PPP funding package.

Lack of institutional experience and skills in Government counterpart - due to their complexity, it is essential that the Government counterparts to PPPs are well-equipped and experienced in undertaking the negotiations to implement such deals, and later to administer them.

Other relevant PPP issues

Balance sheet issues - the use of the PPP mechanism can remove from the Government counterpart direct financial responsibility for the debt and equity raised to undertake the PPP. However, ultimately the PPP mechanism does not remove the Government from the long-term obligation to pay for the services provided under a PPP.

In technical terms, the use of PPP can remove the financial obligations from the Capital to the Current Account of Government, i.e. the obligation becomes a commercial, as opposed, to a financial obligation. This particularly pertains when the PPP periodic (“unitary”) payments are structured as ‘availability’ payments. On the occasion that the customer actually pays for the public service received, e.g. a cash toll-road or bridge, then the financial obligation may be removed totally from the Government Balance Sheet and no public funding contribution is required.

The issue of ‘on’ and ‘off’ balance sheet for PPP is increasingly becoming a critical issue for many Governments. Unfortunately, the underlying guidelines are not precise and International Accounting Standards have not necessarily been written with PPP in mind.

The IMF is aware of this problem¹², but to date no clear benchmarks have been agreed. The issue revolves around contingent liabilities, such as are ‘availability’ payments under a PPP, how such liabilities should be measured, and how liabilities should be reported in public accounts.

The general guideline adopted in the EU¹³ for PPPs is that “if the construction or completion risk and the demand or availability risk are carried by the private sector Concessionaire, then the PPP can be considered as ‘off balance sheet’ for the host Government. In the absence of any more global benchmark, this rule has been informally adopted elsewhere.

¹² International Monetary Fund. 2010. <http://www.imf.org/>

¹³ European Commission. 2010. <http://ec.europa.eu/eurostat>

International lenders to PPPs demand in the Concession Agreement that, in the event of default by either the Concessionaire or the Government counterpart, the full amount of the outstanding debts at the time of default become payable. This principle may at first appear unacceptable to Governments, but given that the lenders will insist on taking security or a lien over the PPP project assets in any event, as part of the terms and conditions of their loans, the principle has some basis. Should default occur, the Government counterpart should not obtain the PPP project assets for nothing.

Regulatory issues - PPPs which provide services direct to the public or customer, for which the customer pays, will require some form of regulation to ensure that appropriate tariffs are charged, the standard of service required is met, and the 'public interest' satisfied.

If regulation for a sector-specific PPP is required, it is important that, just as for a PPP Concession-type law or framework, the regulatory framework and underlying mechanisms are agreed and the institutional framework established before the Government seeks bids for a PPP concession. Given such steps and information, potential international Concessionaires will react much more positively than otherwise might be the case.

Risk Management

In considering the advantages and disadvantages in selecting a PPP for a project, it is of paramount importance to identify, manage and mitigate risks associated with project delivery and operation. Within the current climate there are three key risk factors that influence the success of PPPs including: political, project and financial risk.

Below, project success is viewed from the viewpoint of the promoter of the scheme, which in most cases is the public authority. The key success factors are intrinsically linked to the risk factors and include:

- *Political success*: policy intentions at time of commitment realized upon completion of the project. The policy intentions may include economic, social, development and environmental factors.
- *Project success*: measured in the durability of the scheme over the medium and long term. It also includes the suitability of the project development process (procurement, etc).
- *Financial success*: Outturn of finances with forecasts made at commitment.

Political Factors

2010 brought in the new coalition government between the Conservatives and the Liberal Democrats. This government committed itself to spending £200 billion on infrastructure in the next five years. One of the five areas committed was transport infrastructure. The Commercial Secretary to the Treasury, Lord Sassoon¹⁴ commented that:

- “PPPs will continue to play an important role in Britain’s future infrastructure”
- “Many key PFI projects have proven to be good value for money”
- “Partnering with the private sector, and good use of private finance, brings significant value to complex public infrastructure projects”
- “PPP has brought whole life costing into the public sector; ensured proper due diligence’ and drastically improved the risk assessment of projects.”

This established a positive and supportive central government policy to delivering PPPs. As concluded in a study for *Management, Procurement and Law*, the role of political support in project delivery was more important than project fit¹⁵. The role of high level policy driving projects is evident - even amidst the budget cuts, funding for major transport projects like Crossrail or High Speed 2 have been preserved.

Similarly in the delivery of the Midland Metro scheme, a strong government initiative drove the scheme even though there was public opposition. Ultimately to progress the scheme, a “special parliamentary procedure” advanced the project without public consultation. This parliamentary procedure had only previously been used on rare occasions¹⁶¹⁷. Following the government action to deliver the Midlands Metro scheme, a similar policy has been employed in delivering other LRT projects in the West Midlands.

Even with Government endorsement of PPPs, with the adoption of the Localism bill, local government will play an even more vital role in PPP projects. This in turn will require projects to gain more local and neighbourhood support to ensure delivery. The bill aims to “devolve greater powers to councils and neighbourhoods and give local communities more control over housing and planning decisions.”¹⁸

¹⁴ Lord Sasson. 2010. <http://www.pppforum.com/news/commercial-secretary-treasury-gives-keynote-address-ppp-forum-annual-dinner>

¹⁵ N.J. Smith. 2008. “Political risk in light rail transit PPP projects.” *Management Procurement and Law* 161 Issue MP4.

¹⁶ Midland Metro Bill. 1991. <http://hansard.millbanksystems.com/commons/1991/feb/21/midland-metro-bill-by-order>

¹⁷ Parliamentary Procedures. <http://www.parliament.uk/business/bills-and-legislation/secondary-legislation/special-procedure-orders/>

¹⁸ Localism Bill. 2010. <http://services.parliament.uk/bills/2010-11/localism.html>

In the past local support has proved to be a successful driver in delivery. This is most evident for the Croydon Tramlink PPP. The project was delivered through the joint sponsorship of two strategic local players (London Borough of Croydon and London Regional Transport), which ensured buy-in and ownership, along with understanding of the political requirements to achieving the scheme. This was coupled with strong business support which provided an additional political incentive for the scheme. Without this support Croydon Tramlink would have struggled to ensure successful delivery¹⁹.

In addition to central and local government support, an additional political factor that play a pivotal role is in relation to policy. A shift in public policy at any stage of the project can slow, terminate or accelerate its progression. This may include supplying additional capacity, modified routing, or operational requirements. One of the influential political risks is a shift in policy from private participation to public ownership. This policy cycle is evident in the transferring of railways from public ownership to private investment and now to some extent public ownership yet again. There is a perpetual risk for potential concessionaries that a project will eventually be turned over to public hands.²⁰

It is necessary in the current climate – especially for international investors -to safeguard against these political risks. This may include exit arrangements, insurances or protections to be integrated into PPP contracts and should be addressed at each stage of project development.

Project Factors

Public transport projects by their nature are large, and with size comes complexity of scope, number of stakeholders, governance and procurement. Successful management of these factors is essential to achieving the strict timescales and requirements as part of a PPP contract.

To address evolving constraints, adaptive and responsive mechanisms are necessary to deliver PPPs. In a study conducted by Robert Bain for the European Investment Bank based on discussions with prominent organisation and government officers, PPPs were characterised as being “inflexible and poor at accommodating change.”²¹ These factors coupled with demanding procurement procedures led to poor value-for-money processes. The same study also concluded that some projects may be “too large/complex to be comfortably procured as PPPs” and advised that PPPs achieve the most success when they are “distinct stand alone projects, separable economically and operationally from other activities.”

¹⁹ Allport, Roger; Richard Brown; Stephen Glaister; Tony Travers. 2008. “Success and failure in urban transport infrastructure projects.”

²⁰ Richards, Martin. 2009. “Principles Underlying PFI Schemes”. Public Administration International.

²¹Bain, Robert. 2009. “Review of Lessons from Completed PPP Projects Financed by the EIB” for the European Investment Bank.

An adaptive nature was necessary in delivering each stage of the Docklands Light Railway. Following issues with the construction of the initial two lines of the DLR in 1994, the government decided to privatise the operation of the DLR. With each extension to the DLR, the procurement route was adapted to what would successfully deliver the scheme most effectively. This is what led to the Lewisham extension being adopted through a PFI and the extension was completed ahead of schedule.²²

In addition, a flexible approach to regulation should be employed. This is particularly relevant in the present climate, as the economic conditions are fluctuating impacting inflation and foreign exchange rates. This may include government approval for contract prior to changes, including concessionaire compensation.

The flexible approach was required in Orange County California development of HOT lanes whereby following the opening of the High Occupancy/Toll (HOT) lanes (which were in addition to the existing free lanes), additional capacity was required due to continued traffic growth. To satisfy the “no competition” clause within the concession, the public authority (Orange County) had to buy out the private concession for \$208 million so that additional free capacity could be provided whilst maintaining tolls.²³

Financial Factors

In times of economic austerity the business case for each PPP project should be transparent and robust. Moreover, financial risk should be appropriately transferred to the respective public and private body involved that are most able to manage them. A thorough analysis of risk allocation should be evaluated, including an independent risk assessment with the greater the risk, the higher the cost for providing the service.

To analyse the value for money of a PPP versus traditional procurement, the Treasury’s Public Sector Comparator (PSC) should be used. The PSC accounts for the risk transfer, costs of financing, roles and responsibilities. The “Green Book” on Appraisal and Evaluation advises that “the identification and costing of risks is likely to be one of the more problematic components of the public sector comparator. However, such costing is essential if an unbiased public sector comparator is to be calculated.”²⁴

In an economic fragile environment, this includes demand and revenue risk which are intrinsically linked to economic performance, including employment change. There is little that can be done to

²² Allport, Roger; Richard Brown; Stephen Glaister; Tony Travers. 2008. “Success and failure in urban transport infrastructure projects.”

²³ Richards, Martin. 2009. “Principles Underlying PFI Schemes”. Public Administration International.

²⁴ HM Treasury, 2003. “The Green Book”

control these factors and much could change over the lifetime of the scheme. In a review of case studies by Standard & Poors²⁵, miscalculations that can result include:

- Misjudgment of the willingness of users, in particular trucks, to pay the tolls;
- A tendency to overestimate time savings, and to miscalculate their impacts on their willingness to pay, in part through the use of average or incorrect values of time;
- A failure to allow for what is known as the “ramp up” period, during which it is usual for demand to build up, as users become aware of the advantages of the new road;
- Different economic conditions at opening relative to those anticipated in the forecasts (ie relative downturn)
- Failure of developments (land use) to be completed in accordance with expectations/forecasts
- Improvements in the competing routes

The miscalculation of demand revenue is ever present, especially in fragile political and financial environments. This is the case with the Midland Metro scheme with ridership that plateaued at a third of original forecasts from 2002. There is little that can be done to increase ridership or to extend the line.

In addition, it is of utmost importance to have fair and transparent competition for contracts and to avoid corruption in the selection and award of contracts. With this in mind it is essential to have confidence on behalf of the public authority to receive sufficient bids to ensure a beneficial cost:benefits ratio.

Recommendations/Conclusions

Following the Queen Elizabeth II bridge, PPPs have proliferated throughout the UK and the world. However given the increasing complexities and up-front costs associated with PPP developments, alongside the current climate of economic austerity, the choice of project upon which to impose PPP as the procurement mechanism is key.

From the previous examples and best practice, political, project and financial risk should be effectively managed in these troubled times. While the specific circumstances the schemes were different, several common lessons can be put forward:

- **Political Factors:** Successful projects are often conceived and delivered through central government or local government backing. As the policy shifts more towards local government, it is of paramount importance to gain local support including neighbourhood and business backing in delivering a scheme. However consideration

²⁵ Standard & Poors. 2002. Traffic Risk in Start-Up Toll Facilities.

should be taken to safeguard against policy shifts as we settle into new government policies and priorities.

- **Project Factors:** PPPs are long term investments which need to evolve and adapt to the surrounding context. This includes adapting procurement or operations measures as necessary, along with being responsive to regulation changes.
- **Financial Factors:** With a financially sensitive environment it is more important than ever to have a sound and robust business case to deliver a scheme. This includes a rigorous review of the cost-benefit analysis; accurate demand and revenue forecasting; fair competition; and good risk allocation and management.

The promising allure of PPPs in today's climate offer an opportunity to delivery schemes with greater efficiency through the private sector versus the public sector. However in the current climate, additional complexity and evolving risks can offset the gains. In determining whether PPPs are the most suitable project structure a rigorous exercise must be undertaken to evaluate the wider risks, issues and implications of the project and the political, project and financial context. It is with this consideration that we can assess the prospects for the future with an appreciation for past lessons learnt.

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