Plenary 3: Public sector 'for & against' PPPs

Monday, 14:00 to 15:00

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Session agenda

1. Introduction

2. PPP & the Budgetary 'benefit'

3. Pros and cons of PPPs
   - Public sector considerations
   - Impact of private sector involvement

4. Reasons for not using PPPs

5. Summary and further reading

Introduction

Debate on the merits and demerits of PPPs is a complex one. Wide variety of arguments used by governments for using PPPs – many of these are *ex-post* in nature, i.e. used to justify a decision which has already been taken for budgetary reasons

Issues for consideration:

- Whether PPPs provide 'additionality' of investment in public infrastructure
- Economies of scale
- The benefits of whole-life costing and maintenance
- Value added through the use of private-sector skills
- The high financing costs implicit in PPPs
- Whether risk transfer and value for money can be offset against higher financing costs
- Complexity
- The effect of PPPs on public-sector flexibility

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PPP – Public expenditure implications

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The Budgetary 'Benefit' – PPPs make projects affordable

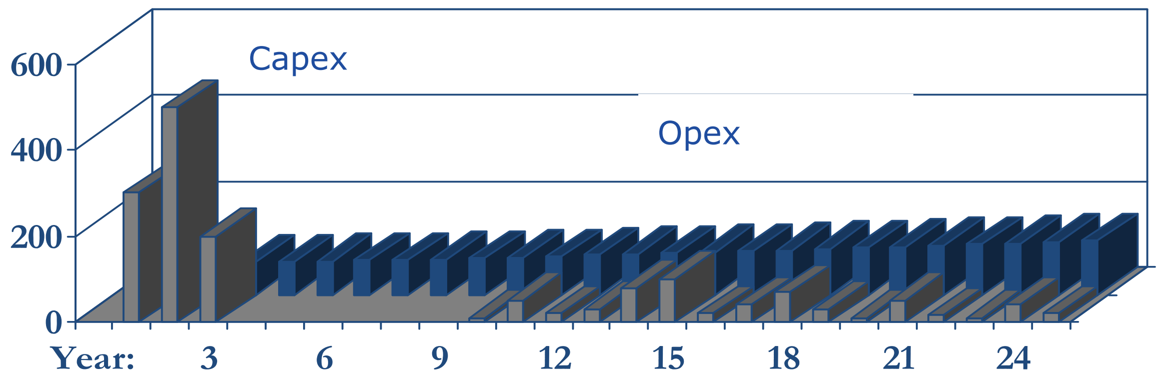
The primary reason for the use of PPP is that a PPP project will not require public-sector funding today.

'Traditional' Public Sector Procurement	PPP
• Capital costs charged immediately against the public sector budget	• Private sector finances construction costs • Costs then recouped over time through either payment of service charges by authority or revenues from project (e.g. user charges)

- PPP is a vehicle for the public sector to overcome short-term budgetary and fiscal constraints on investment in public infrastructure imposed by insufficient tax revenues or limits on public sector borrowing
- In circumstances when the public sector does not want to, or cannot, increase its direct levels of borrowing, PPPs make projects affordable.

PPP - Public expenditure implications

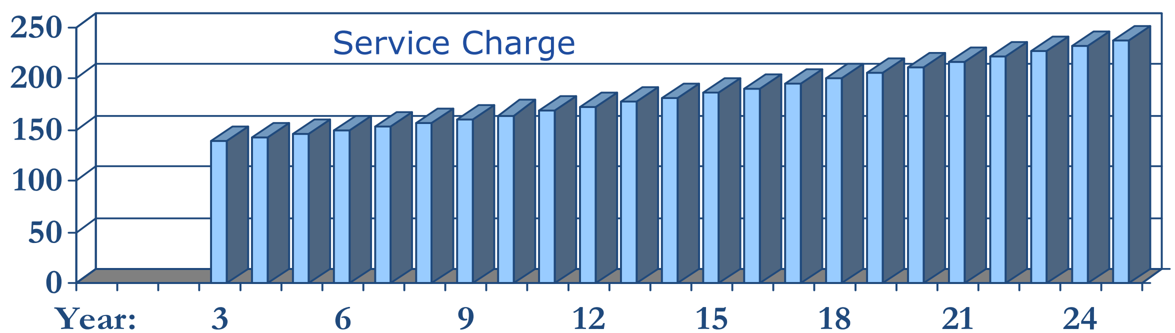
Traditional Public sector procurement:



£2.13bn

NPV

PPP:



Under PPPs, the private sector finances the construction of the project and is repaid by a service charge from the authority over time or by revenues from the project, or a combination of the two

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The Budgetary 'Benefit'

Should the use of PPP to avoid public-sector funding today be seen as a 'benefit'?

- ✓ Project may become more affordable within budgetary constraints
- ✓ Project may become more affordable because out-turn cost is fixed and uncertain downsides are avoided
- ✗ PPPs are a pragmatic solution to overcome a legal impediment e.g. Maastricht Treaty limitations on budget deficits in European Union
- ✗ PPPs nothing more than 'off-balance sheet borrowing'?
- ✗ PPPs create fiscal rigidity because of their long-term commitments

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Additionality

Additionality is a frequently used argument in favour of PPPs - PPP enables investment in infrastructure which would not otherwise have been possible or would have been delayed until later.

> **"PPPs make additional projects affordable. By attracting private sector finance for schemes suited to the PPP model, limited public sector funds can be directed to deliver other non-PPP projects"**

Julie O'Neil, Secretary General of the Irish Department of Transport

- Macroeconomic argument that if public investment increases, private investment decreases ➞ net result the same
- Little evidence that PPPs 'crowd out' private-sector investment
- PPPs undertaken in addition to (rather than as a substitution for) other forms of public sector investment

Economies of scale

Because PPP allows investment in public infrastructure to be accelerated, a project which may have otherwise been procured by the public sector in several parts (e.g. a road widening project let in sections,) can be procured as a whole

Economies of Scale should enable total project costs should be reduced e.g.

- Economies in planning
- Economies in procurement
- Economies in construction

… assuming the greater PPP project size does not create capacity problems in the local construction industry, resulting in an increase in prices

Budgetary Certainty & Flexibility

PPPs deliver budgetary certainty

- At financial close future costs of PPP project are known
- Public sector will receive known outputs for known costs

Limitations:

- Indexation
- Benchmarking/ market testing – cost of delivering underlying services is re-examined
- Service variations, leading to additional costs

Trade off for budgetary uncertainty is relative inflexibility to make changes to the use of assets or type of services offered

Other public sector considerations

Pros	Cons
• Revenue linked to service provision • PPPs force public sector to make provisions for maintenance • PPPs force public sector to focus on outputs and benefits from the start • Quality of service is maintained for the life of the PPP • Public Authority can act as ‘regulator	• Loss of management control by the public sector

Whole life costing & maintenance

PPPs require the private sector to compete to deliver a service over the long-term at the most economically advantageous price

- Whole-life cost = the combined costs of initial asset construction, routine maintenance and capital replacement works/ lifecycle costs
- Focus on long term cost rather than immediate capital spend,

PPP creates an incentive for the private sector to take whole life costing into account because:

- the same investors will be responsible for both the construction of an asset and its operation
- maintenance cost risk is transferred to the private sector as part of the PPP Contract
- having capital at risk ensures that ProjectCo cannot easily walk away from this risk.

Private-sector skills

PPPs require the private sector to:

- Deliver assets on time and on budget
- Ensure those assets deliver the service levels required by the public sector
- Project manage the overall delivery of the project
- Ensure ‘integration of project, i.e. that the individual assets and other elements of the project that have been procured work together to successfully deliver services
- Maintain and refurbish assets on an effective basis, so that services are delivered without interruption at satisfactory levels over the long-term

PPPs therefore offer significant opportunities to benefit from private sector skills

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Private-sector skills

'Skill'	Issues for consideration
Project management • Private sector has greater expertise in managing complex projects	• PPP projects can be managed by the private sector without private-sector finance
Single-point responsibility • PPP provides public sector with a single point of responsibility for construction and operations, avoiding 'interface' problems	• Possible to create a structure to achieve this result without using private-sector financing
Efficiency • Private sector is fundamentally more efficient than the public sector because of its profit motive	• In a PPP context the private sector is not paid for being efficient, but for performing what is required under the PPP contract. • The required level of efficiency in a PPP contract is 'fixed' through the Performance Regime, so there is limited opportunity for the public sector to benefit from efficiency savings over the life of the contract • Because there is no competition after Contract signature, the private sector is not incentivised to pass efficiency savings on to the public sector
Innovation • 'Output-based' specification of PPP projects allows public sector to benefit from innovatory private sector approaches	• Limited scope for innovation in 'commoditised' PPP markets • Private-sector bidders often recruit public sector staff to supplement bed teams and enhance sector knowledge

Private-sector capital

Pros	Cons

Pros

- **Capital at risk**

  Private sector investors and lenders have capital at risk and therefore greater financial incentive to ensure that the PPP contract is performed adequately

- **Third-party Due Diligence**

  A lender's involvement will mean that a a third party (apart from investors and the public sector) will review the project's viability

- **Contract monitoring**

  Lenders require regular information updates

Cons

- **Project selection**

  The involvement of the private sector can distort the types of projects which go down the PPP route

- **Asymmetry of information**

  Private sector has greater market knowledge than the procuring authority, giving them a competitive advantage and stronger negotiating position

- **Complex & lengthy process; high procurement costs**

- **Private sector profits at public's expense**

Financing cost & risk transfer

The private sector's cost of capital is typically 1-3% higher than the public sector's cost of debt on a non-risk adjusted basis …

… because lenders to a PPP are taking a greater **risk**

Two opposing schools of thought…

a) In a publicly funded project, project risks are retained by public sector constitute a hidden cost of the project

b) Public sector is better able to spread risks than the private sector – hence the real cost of public-sector funding, even taking account of risk, is actually lower than financing by the private sector

We will explore issues of risk transfer and value for money further in Plenary Session 9 tomorrow

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Reality of risk transfer – 'privatising profits, socialising losses'

Risk transfer is a key element of the value for money argument of PPPs – but what happens if a PPP goes wrong?

- Private-sector investors may lose any equity investment, but there is no obligation on them to commit further money to rescue the project
- Public sector's objective is to ensure that PPP continues to provide contracted service so either:
    - It allows the PPP to fail and then incurs extra costs to maintain the public service (Metronet); or
    - It provides extra support for the project rather than terminate the PPP Contract (Channel Tunnel) – this will usually involve taking back responsibility for risks that had been transferred to the private sector (e.g. traffic flow)

Either way, the intended risk-transfer benefit of the PPP is negated

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Issues for consideration:

- Does sufficient private sector expertise exist to warrant a PPP approach?
- Does the public sector have sufficient capacity and skills to adopt the PPP approach?
- Transparency and accountability
- Is the project suitable for a PPP structure?

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Summary

- PPPs offer an opportunity for moving the timing of infrastructure investment forward
- Can also create benefits through greater transparency, efficiency etc
- Also a greater opportunity to link payment to performance (often referred to as Output Based Aid or Performance Contracting)
- BUT there are also drawbacks
- Real risk transfer may be hard to achieve
- Future budget flexibility is lost…..

Further sources

Online

1. PriceWaterhouseCoopers (2005) “Delivering the PPP promise: A review of PPP issues and activity"
   http://www.pwc.com/gx/en/government-infrastructure/delivering-ppp-promise.jhtml

Books

1. Yescombe (2008) “Public-Private Partnerships: Principles of Policy and Finance”