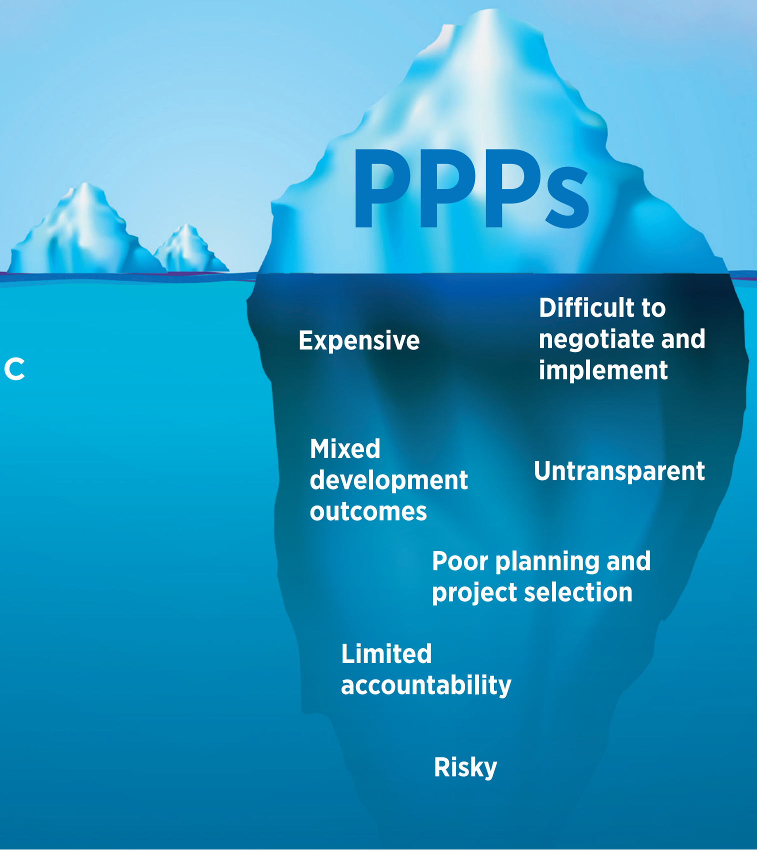
Summary report

# What lies beneath?




## A critical assessment of public private partnerships and their impact on sustainable development

By María José Romero

Public-private partnerships (PPPs) are increasingly promoted as a way to finance development projects. Donor governments and financial institutions, such as the World Bank, have set up multiple donor initiatives to promote changes in national regulatory frameworks to allow for PPPs, as well as provide advice and finance to PPP projects.

PPPs feature prominently in discussions around the post-2015 and financing for development agendas. Currently, there is a strong push to increase the involvement of the private sector in the development arena and to promote PPPs as a key tool to reach the 2015 sustainable development goals.

The last decade has seen a huge increase in the amount of money invested in PPPs in developing countries. From 2004-2012, investments in PPPs increased by a factor of six, from US$ 22.7 billion to US$ 134.2 billion. This has been driven by economic growth and thus the need for infrastructure development, but also by low interest rates in developed countries driving investors to 'search for yield' elsewhere. Although investments fell in 2013 to US$ 84.4 billion, current estimates show that the developing world will experience a new wave of PPPs in the near future.

Despite the promotion of PPPs, private finance only provides about 15–20 percent of total infrastructure investment. The lion's share is still, and will likely continue to be, provided by the public sector. Therefore, questions remain about why so much focus is placed on the private sector rather than improving public sector delivery.

This report looks at the empirical and theoretical evidence available on the nature and impact of PPPs, and analyses the cases of Tanzania and Peru. It critically assesses whether PPPs deliver on the promises of their proponents and gives concrete recommendations for policy-makers.

**The report finds that:**

- **PPPs are, in most cases, the most expensive method of financing, significantly increasing the cost to the public purse.**
- **PPPs are typically very complex to negotiate and implement and all too often entail higher construction and transaction costs than public works.**
- **PPPs are all too often a risky way of financing for public institutions.**
- **The evidence of impact of PPPs on efficiency is very limited and weak.**
- **PPPs face important challenges when it comes to reducing poverty and inequality, while avoiding negative impacts on the environment.**
- **Implementing PPPs poses important capacity constraints to the public sector, particularly in developing countries.**
- **PPPs suffer from low transparency and limited public scrutiny, which undermines democratic accountability.**

Overall, this report shows that promoting PPPs in a non-critical way is a mistake. Governments and financial institutions should focus on developing the right tools at country level to identify whether – and under what circumstances – it is desirable to use PPPs.

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## What is a PPP?

PPPs are not new, but there is also no universally agreed definition of the term. The acronym PPP is used in development discourse to identify very different types of arrangements. This generates an incredible amount of confusion and makes constructive debate about PPPs' contribution to financing development needs difficult.

For the purpose of this report, we use the most widely accepted definition of PPPs. Here, they are described as:

- **a medium- or long-term contractual arrangement between the state and a private sector company;**
- **an arrangement in which the private sector participates in the supply of assets and services traditionally provided by government, such as hospitals, schools, prisons, roads, bridges, tunnels, railways, water and sanitation and energy;**
- **an arrangement involving some form of risk sharing between the public and private sector.**

This definition helps us set out the limits of what is and what is not a PPP. However, there is not always a clear cut-off point and there are differences across economic sectors, geographical regions and even between countries in the same region. Currently, more and more countries are including their own definitions in national laws and policies. This implies that they might mean different things when PPPs are negotiated at the global level.

The vast literature on PPPs reveals up to 25 different types of PPPs. These result from some combination of the following functions performed by the private sector: design; build; develop; rehabilitate; finance; operate; maintain; own; transfer; and lease. The use of specific types varies greatly across sectors and countries. In addition, a dual typology emerges from classifying PPPs in relation to the source of the private sector revenue.

a) **'User pays'**: The private partner is allowed to charge the public for using the facility, generally through paying a toll (e.g. water rates or motorway tolls), which can be supplemented by subsidies paid by government. The toll reimburses the private partner for the cost of building and operating the facility. This model is common in road building and is most often used in Latin America.

b) **'Government pays'**: The private partner's payment comes from regular payments by the public partner based on the level of service provided. The payments can depend on the asset or service being available at a contractually-defined quality or on the services delivered to users—such as a 'shadow toll' road, which is free for users, but where the governments pay a fee per driver to the operator. The Private Finance Initiative programme in the UK is an example of this.

In practice, there is often some mixture of both public and user funding for either the construction and/or the service element.

## Why use PPPs?

Public and private sector actors have different incentives to engage in PPPs. Arguments in favour of PPPs may include the capacity of the private sector to deliver high-quality investment in infrastructure. Private sector participation may also reduce the need for the state to raise funds upfront. Instead of building infrastructure with capital upfront, PPPs use annual instalments from revenue budgets or user fees to pay for infrastructure. In this way, governments do not need to directly take loans, but costs will appear either in future periods (as a government assumes a future debt), or be absorbed by users. Although PPPs represent a form of borrowing, the difference in the timing of the cash flows creates a strong bias in favour of PPPs. Current austerity measures and accounting practices also create perverse incentives as governments are allowed to keep the PPP project and its contingent liabilities hidden.

From the private sector perspective, the profitability of projects is crucial. Depending on the sector and location, PPPs represent an attractive business opportunity for companies, like construction and engineering firms, service providers and banks. The delivery of infrastructure projects traditionally carried out by the public sector represent for the private sector the 'next frontier to conquer.' This is particularly the case for institutional investors (such as pension funds, insurance companies and sovereign wealth funds), who hold trillions of dollars and seek to diversify their portfolios, and so reduce the risks to their investments. PPPs offer a less risky way of investing for the private sector, as they guarantee an income for a long period of time, which is normally largely underwritten by the government itself.

## The challenges of PPPs

Making a PPP work can be very difficult. It requires careful consideration of whether they are the best mechanism, and how they should be structured. The evidence also shows that they can often go wrong, sometimes very badly.

We used the following framework to analyse PPPs, taking into account:

A. **Budgetary affordability of PPP options as compared with public procurement alternatives;**

B. **Level of efficiency in delivering services**, including a fair and comprehensive risk assessment;

C. **Poverty reduction and the fight against inequality,** which means assessing the sustainable development impacts of PPPs;

D. **Democratic systems in place to negotiate, manage and monitor the project.** This includes reflections on transparency and accountability mechanisms.

**We found that:**

**PPPs are, in most cases, the most expensive method of financing, significantly increasing the cost to the public purse.** A 2015 review by the UK's National Audit Office (NAO) finds "that the effective interest rate of all private finance deals (7%–8%) is double that of all government borrowing (3%–4%)." This means that the cost of financing PPP projects can be twice as expensive for the public purse than if the government had borrowed from private banks or issued bonds directly. In addition, private sector companies can be expected to make a profit on their investment, which in the case of 'government pays' PPPs has to be added to the overall cost of the investment, while in the case of 'user pays' PPPs this is going to increase the cost for the users. For developing countries, the returns required by investors are higher than in developed countries, due to higher perceived risks.

**PPPs are typically very complex to negotiate and implement and all too often entail higher construction and transaction costs than public works.** PPPs' high tender and transaction costs, along with complicated and long-term contracts, means that few companies have the capacity to apply for projects, reducing governments' choice and competition in tendering processes. PPPs are all too often renegotiated. In most cases this renegotiation process entails important costs for the public sector due to the lack of competition and transparency, and the privileged position of the private sector company. Overcoming planning and project selection problems is also critical for reducing the final cost of the project. However, all too often PPPs suffer from a strategic overestimation of demand. This happens due to weaker incentives for rigorous analysis on both the private and the public sector sides. For instance, in Tanzania, a PPP project saw the state-owned electricity company Tanesco sign a power purchasing agreement with Independent Power Tanzania Limited (IPTL). This deal was highly contested on the grounds of cost and the projected demand for power. There were also allegations of corrupt payments to government officials and planning problems. The project was approved by three government officials without a proper feasibility study, which would have shown that the problem was not insufficient generating capacity, but a lack of gridlines.

**PPPs are all too often a risky way of financing for public institutions.** The historical experience of several countries in the developed and developing world shows that PPPs can pose a huge financial risk to the public sector. A report launched in 2014 by Oxfam and the Lesotho Consumer Protection Association shows that a PPP hospital cost US$ 67 million per year – at least three times what the old public hospital would have cost today, and it consumed more than half of the total government health budget. The fiscal implications of PPPs come from non-transparent contingent liabilities (or risk of debts in the future) and the expectation of the public that the state should ensure the public provision of services. If a project fails – and this is not infrequent – the costs are shouldered by the public sector, which has to rescue the PPP project, or even rescue the company, which results in private debts being shifted to the public sector.

**The evidence of impact of PPPs on efficiency is very limited and weak.** PPP supporters argue that most of the additional cost of private over public finance is justified because of efficiency gains. However, research indicates that, in most cases, efficiency gains depend on the sector, the type and size of projects, the private sector increasing capital investment as contractually agreed, and the country context. A 2009 WB report on private participation in electricity and water in developing countries in the past 25 years points to an increase in efficiency gains, but at the same time it points to a lack of investment of the private sector, and to a failure to lower prices for consumers. One plausible explanation for this is that the "the private operator reaps all the gains through profits."

**PPPs face important challenges when it comes to reducing poverty and inequality, while avoiding negative impacts on the environment.** The evidence shows that the impact of PPPs on development outcomes are mixed and vary greatly across sectors. PPP projects have to be commercially viable or private companies will not sign up to them as they are looking to maximise profits. This limits the extent to which PPPs can succeed in areas which are not at first going to be profitable. While in some cases private participation results in improvements in service delivery, private companies have a greater incentive to strip out any elements of a service that might reduce their potential profits, including cutting jobs. Where there are political demands to cut public spending, the existence of PPPs creates greater threats to other spending on public services. Furthermore, the impacts of PPPs on the environment are even less well researched and systematically considered. Although financial institutions, such as the World Bank, have social and environmental safeguards for their operations, the implementation of those safeguards has also been an issue on the ground. In the last decade local communities have submitted many different complaints to the institutions' redress mechanisms in relation to the environmental and social impacts of PPP projects.

**Implementing PPPs poses important capacity constraints to the public sector, particularly in developing countries,** where systems to do this well might not be in place. It takes both time and experience to establish capacities, which does not always allow the urgent need for particular services to be met. Although many efforts to change the regulatory framework have been made, this does not result in immediate improvements, as the cases of Peru and Tanzania covered in this report illustrate. Monitoring is also challenging. It often does not cover the lifespan of the project, and thus, does not register the the project's impact on the ground.

**PPPs suffer from low transparency and limited public scrutiny, which undermines democratic accountability** – including proper redress of affected communities – and offers greater opportunities for corrupt behaviours. Although there is rhetorical recognition of the importance of transparency and stakeholder participation, in practice they are still missing and in some cases PPP projects have triggered community opposition and government repression. As the cases of Peru and Tanzania show, experiences at country level is mixed. In Peru, for instance, there have been some agreements reached with indigenous communities, but there are also cases where communities have demanded, through mass demonstrations, an open and transparent process of public consultation.

## Changes in, and implications of the PPP regulatory framework

**The case of Tanzania:** The 2011 PPP Act changed the institutional setting for managing PPPs. It established two new units: a PPP Coordinating Unit within the Tanzania Investment Centre to coordinate and promote PPPs, and a PPP unit in the Ministry of Finance (MoF) to assess PPP projects that involve public finance.

The work of these two PPP units present some clear challenges. The mere existence of two units might imply a high risk of duplication of labour and bureaucracy. In addition, since the PPP units are within government institutions, questions could also be raised about their independence and possible conflict of interests.

A report on contingent liabilities commissioned by the MoF points out many shortcomings of PPP regulation with practical implications in managing PPPs. The report recommends that the PPP Act should clarify institutional responsibilities and functions; specify the types of financing modalities permitted; include a description of the various risks to be shared between private and public sector; and include the sustainable debt limit, defining whether guarantees are included in the total debt limit or not.

**The case of Peru:** ProInversión is the state agency mandated to promote the use of private investment in the provision of public services and infrastructure, and to provide technical assistance. It reports to the Ministry of Economy and Finance, but it has technical, operational, administrative, economic, and financial autonomy.

In 2008, after the global economic and financial crisis, the Framework Law on PPPs was reformed. This led to a relaxed framework aiming to facilitate concessions for projects primarily related to ports, airports, roads, highways and residual waters. Some of the main changes introduced in 2008 included: changes in the cost-benefit calculation to simplify the use of the 'value for money' methodology; the obligation of each state agency to reduce bureaucratic obstacles to getting permissions, licences and authorisations to implement projects; and delimiting the opinion of ministries to the sphere of their legal competences, thus leaving to ProInversión the possibility of unilaterally determining whether and when to ask for the regulator's opinion.

According to the Economist Intelligence Unit magazine on PPPs in Peru, weak regulation of contracts allows frequent re-negotiations and the opportunistic behaviour of private sector companies, as well as ambiguities about the different stakeholders' responsibilities. For instance, according to official figures, the Inter-oceanic Highway (Carretera Interoceánica) had an initial investment amount of US$ 0.8 billion, which in the end reached to US$ 2 billion, due to consecutive renegotiations. Despite recent changes, the legal framework still needs to be consolidated and further developed to address problems in assessing costs, and in applying a useful methodology for selection and monitoring.

## Recommendations

As this report is published, the post-2015 and the financing for development agenda are being negotiated. PPPs are proposed as a key component of the financing for development agenda in response to pressing infrastructure needs. However, it is crucial to take into account what has happened so far and examine whether PPPs will help the world's poorest countries to finance the roads, schools, hospitals, energy and other infrastructure facilities they need to grow.

We recommend concrete actions that can have a crucial impact in this debate.

**a) Stop hiding the true costs of PPPs:**

- As PPPs are an expensive form of debt, sensible accounting practices should be adopted, for instance:

- Include PPPs in national accounts, i.e. they get registered as a government debt, and therefore are part of debt sustainability analysis, rather than being off balance sheet; and

- Explicitly recognise the risk of hidden contingent liabilities should the project fail, through adequate risk assessment

- Select the best financing mechanisms, including examining the public borrowing option, on the basis of an analysis of the true costs and benefits of PPPs over the lifetime of the project, taking into account the full fiscal implications over the long-term and the risk comparison of each option.

**b) Be transparent and accountable:**

- Governments should proactively disclose documents and information related to public contracting in a manner that enables meaningful understanding, effective monitoring, efficient performance, and accountability of outcomes. According to the Open Contracting Global Principles, this would require proactive disclosure of:

i. Contracts, including licenses, concessions, permits, grants or any other document exchanging public goods, or resources and any amendments thereto.

ii. Related pre-studies, bid documents, performance evaluations, guarantees, and auditing reports.

iii. Information concerning contract formation, including the planning process of the procurement; the method of procurement and the justification thereof; the scope and specifications for each contract; the criteria for evaluation and selection; the bidders in the process and any procedural exemptions for which they qualify; and the identity of the contract recipient and any statements of beneficial ownership provided.

iv. Information related to performance and completion of public contracts, including status of implementation against milestones; dates and amounts of payments made or received and the source of those payments; arrangements for ending contracts; final settlements and responsibilities; risk assessments, including environmental and social impact assessments; provisions in place to ensure management of ongoing risks and liabilities; and appropriate financial information regarding revenues and expenditures, such as time and cost overruns, if any.

- For major infrastructure projects, governments should allow for good and democratic governance through informed consultation and broad civil society participation and monitoring, including by local communities, trade unions and others. Government should also ensure the right to redress for any affected communities.

**c) Put development outcomes at the forefront:**

- Projects should be designed and selected to benefit everyone in society through the delivery of sustainable development outcomes, in agreement with national and democratically driven development strategies. This means ensuring affordability of the services for the public sector and the users, as well as addressing equity concerns in terms of equitable access to infrastructure services, and avoiding negative impacts on the environment.

- Governments should develop clear outcome indicators and effective monitoring to measure the impacts of PPPs on the poor, from the project selection phase to the operational phase of the project.

**d) Put developing countries in the driving seat:**

- As part of the follow up of the Third Financing for Development Conference, governments should hold inclusive, open and transparent discussions, under the auspices of the United Nations, on developing a set of comprehensive and development-focused principles and criteria for the use and assessment of PPPs. Until this happens, the World Bank and other financial institutions and donor governments should stop promoting PPPs as the preferred way to invest in infrastructure.

To read the full report go to: www.eurodad.org/whatliesbeneath.

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