Public Private Partnerships: Historical, Theoretical and Practical Framework

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Current Reform Context

- PPPs are part of New Public Management (NPM), a “tidal wave of government sector reform” that has swept the world since the 1980s (Kettl 1999).

- Forces Shaping the NPM Debate:
  1. Globalization
  2. Deregulation and Demonopolization
  3. Ideology (conservative or neo-liberal)
  4. Consumer Choice
  5. Populist Forces
Brazil

- Bresser-Pereira led the Federal Administration to Reform the State (MARE).
- From bureaucratic to managerial administration.
- Creation of autonomous government agencies operating under performance contracts.
- Creation of a non-state public sector (NGOs)
- Constitutional reform
  - Brazil had significant decentralized in 1988 Constitution
- Privatization and creation of new regulatory agencies
Elements of NPM

1. Reducing or redefining the role of government ("steering, not rowing").
2. Privatization and competition to overcome the monopoly nature of government services.
3. Customer/client focus—citizens desire same quality they expect from private sector.
4. Decentralization/devolution of authority; creating more flexibility for line managers.
5. Outcome orientation—shifting emphasis from inputs to measures of effectiveness.
6. Transparency and accountability—allowing citizens to see how well government is doing.
Philosophical Foundation of NPM

- Dual and sometimes conflicting goals of NPM:
  - Reduce the state; reform/reinvent the state
- Reduce the state follows a neo-liberal economic philosophy of limited government
- Reform the state has conflicting attitudes about public workers:
  - Forced accountability and incentives
  - Free the workers to act more creatively, entrepreneurially
- Pragmatism in the US has led to experimentation in how government goods and services are provided.
Expectations and Results

- Results of Administrative Reform often fall short of expectations: Why?
  - Fiscal dominance over management improvements.
  - Difficulty reconciling private incentive-based system with legal/political requirements.
  - Lack of legal, regulatory, monitoring capacity.
  - Lack of widespread political support; interagency power struggles.
  - Hard to overcome existing culture/processes.
Public Private Partnerships

- PPPs grew in importance and usage since the NPM movement, but PPPs are not new.
- Public-private partnerships have existed worldwide at least since the time of the Romans.
  - Use of private tax collectors.
- United States since its founding:
  - During the revolutionary war, the Continental Congress authorized the use of privateers to harass the British Navy.
Historical Context

- Governments use private sources for the supply of inputs to public services: e.g., buildings, roads, military hardware, etc.
  - Government generally financed, controlled specified, and operated.
  - Also ancillary services: e.g., janitorial.
- Private sector also has provided quasi-public services for a fee--when it could restrict entry and usage.
  - Toll roads, private schools, etc.
PPPs Defined

Public-private partnerships are ongoing agreements between government and private sector organizations in which the private organization participates in the decision making and production of a public good or service that has traditionally been provided by the public sector organization and in which the private sector shares the risk of that production.
What PPPs are Not

- Not simply “Outsourcing.”
  - This is often a “make” or “buy” decision on how to provide a portion of a public good or service.

- Not Privatization.
  - Privatization involves the transfer of some activity and its assets that had been operated by the public sector to the private sector, via a sale or some other mechanism.

- Not simply “Contracting.”
Contracts vs. PPPs

Contracts

- Specification of good or service needed.
- Arms-length, RFP and bidding process.
- Bidding selected on best price (traditional).
- Governments role: monitor contract-compliance.
- Risk mostly with government.

PPPs

- Description of output desired.
- Negotiated process with multiple possible partners.
- Decision based on best “value for money.”
- Government is a partner, monitors results.
- Risks shared between private sector and government.
PPPs, PFI and Infrastructure

Government’s have often used the private sector to construct major infrastructure facilities, using standard contracts.

However, such contracts do not create a partnership in the sense we have described.

PFI/PPP in the UK, began to involve the private sector in shaping, financing and operating new or renovated infrastructure.

Concept as many variations.
Infrastructure Comparisons

**Hard**

- Economic:
  - Roads and Railways
  - Ports and Airports
  - Power
  - Telecommunications

- Social:
  - Hospitals
  - Schools
  - Water
  - Prisons

**Soft**

- Economic:
  - Vocational Training
  - R & D Facilitation
  - Technological Transfer

- Social:
  - Social Security
  - Community Services
  - Environmental Programs
Private Finance Initiative: What is it?

- PFI is a process of involving the private sector in the design, financing, construction, and operation of facilities that provide public services.
  - Bringing private sector $ and expertise.
- PFI attempts to shift the risk of performing from the public to the private sector.
- PFI involves the purchase by the state of a stream of services.
British history of Privatization began during the Thatcher Government in the 80s.

John Major, who succeeded Thatcher, introduced PFI as a method of providing state services (w/o unions) without increasing public sector borrowing.

Tony Blair, labor party, accepted the PFI concept as a way of extending state services.

Re-titled it “Public Private Partnerships” (PPP)

20 billion pounds in PFI projects in the UK
PFI: How Does it Work

- Agencies/government define a public sector need and specific service requirements.
- Develop a public sector cost comparator.
- Create bidding documents:
  - Specification of output required not the how.
- Consortium of private sector includes finance, construction and operational firms.
- Selection of best consortium.
- Development of long-term contract.
PFI: Criteria for Selection

- Amount of risk shifted from public sector to private sector.
- Ability of private sector to finance capital infrastructure over a long-term period.
- Management expertise and ability to provide “value for money.”
Value for Money

- Risk transfer to private sector including construction and operation costs, technological change, and the long-term fit between a facility and its public purpose.
- The use of an output-based service specs--delivery of a certain level of service.
- Competition in the bidding process lowers cost of capital and services over the long-term.
- Performance measurement and incentives are developed and used as the basis for holding the PFI provider accountable for results.
The Theory Behind PPP/PFI

- Competitive Markets
  - Competition lowers costs
- Private Ownership Creates Efficiency
  - Incentives
- Solving principal-agent problems.
  - Adverse Selection; Moral Hazard
- Government focus on the “What” not the “How” [Steering not rowing?]
- Accountability for outputs not inputs.
Competition Insures Efficiencies

- The superiority of the market model assumes an open competitive environment.

- Limitations:
  - Private sector often works in a non-competitive environment (monopoly or oligopoly)
  - Other “market failures.”
  - Enron and other problems
  - Transactions costs may be underestimated.
  - PPP/PFI may only make sense in large or replicable projects.
**Private Ownership Incentives**

- **Ownership** creates incentives for greater productivity. (Property rights and corporate governance theory).
  - Because property rights are transferable (sale of business or stock) it forces efficiency in production: ownership will go to those that have a “comparative advantage.”
  - In contrast, public ownership is diffuse and accountability indirect (through electoral process).
Principal-Agent Theory

- Both Public and Private Ownership have agency problems: how can the principal ensure that the agents will perform the work in an efficient manner.

- **Adverse Selection**: the hidden information problem—principal does not have full information on agent’s capacity, goals, etc.

- **Moral Hazard**: the hidden information problem--principal has incomplete knowledge of agents actions.

- Is private sector better able to deal with the agency problem?
How PFI Works:

Public Sector Entity
State or Local Government

Output Specification
Defined Risk Transfer

SPV Special Purpose Vehicle Company

25 year Service Agreement
Construction Contract
Facility Services Agreement

Insurance
Only Residual Risk Transfer

Financial Providers
Banks or Bondholders

90%
10%

Shareholders
Contractor
FM Provider
Financial Investor
Public sector procurement, the theory

This is what is supposed to happen

Start-Up Capital Costs

Operating & Maintenance Costs

$
Public sector procurement, in practice

This is what actually happens

Cost & time overruns

Start-Up Capital Costs

Operating & Maintenance Costs

(time)
Public Sector Procurement, PFI

Capital, O & M Costs =
Public sector payments to private sector

No payment until facilities are available to public
Keys to a Successful PPP Contract

☞ Service requirement must be an “output spec”, not prescriptive
☞ Focus on service provided, not the asset itself
☞ Service must be measurable to be tied to payment
    ☞ availability of asset, or actual volume of usage
    ☞ penalties tied to measurable performance
☞ Revenue stream must be reliable and predictable
☞ Project must be considered “bankable” by lenders
☞ Genuine and appropriate risk must be transferred
☞ Private sector efficiencies must be significant to offset higher cost of borrowing
Private partners must have freedom to achieve significant savings
Standard Criteria Categories

- **Sufficient Freedom to Control:**
  - Design Specs
  - Engineering/Development
  - Life Cycle Costs
  - Operational Labor Costs
  - Maintenance
  - Service Pricing
  - Technology Refresh

- **Strong Project Sponsors/Partners**

- **Adequate Lender Appetite**

- **Acceptable Risk Allocation**
The Bottom Line for the Public Sector

- Public benefit arises from services provided
  - not from the ownership of assets used to deliver the service
- Management and maintenance of assets over their lifetimes are greatly influenced by the original design
- Cost and productivity efficiencies can be achieved by allocating risks to those who can best manage them
- Intense constraints on public funding makes alternative methods of financing not just a novel idea, but a necessity
The Bottom Line for the Private Sector

- Private financing is readily available for capital projects with solid, reliable revenue streams
- Contractors must be willing to accept and manage risks that are normally borne by the Public Sector
- Concession agreements can establish long term, locked-in business relationships with Govt customers
- Bid costs for privately financed projects can be significant
Public Sector Issues with PPPs

- Ability to define output over long term
- Cost of capital
  - Government should be able to borrow at lower costs.
- Process versus output
  - Is the way a service is delivered important?
- Equity concerns
- Transaction costs
- How much risk to shift?
Lessons Learned from the UK

❖ Private Finance Initiative: Transportation Illustration
❖ Used in the UK since the early 1990’s,
❖ The UK Highway Agency has completed over 260 PPP/PFI highway projects (these are national highways, not local roads) in England (Wales and Scotland operate separately) since 1994,
❖ costs overruns incurred: £0,
❖ Re-defines the relationship between government and private sector to better serve the citizen, while providing accountability.

Lessons Learned from the UK

Methods for funding roads projects:

- **Toll Scheme**
  - Demand risk falls on private sector (new roads lower demand, thus lower tolls)
  - Political issues

- **Shadow Tolls**
  - Government payments based on usage
  - Raises government’s cost of monitoring
  - Does not address demand risk

- **Road Capacity**
  - Private provider is paid (or not) on availability of the road
  - Requires monitoring of quality of private service
  - Demand risk falls to public sector
Key Policy Questions

Does the current approach to financing & managing public services deliver the best deal to the taxpayers (value for money)?

Do PPPs retain public accountability (citizens vs. consumers)?

What is the role of government in ensuring appropriate accountability in the public interest?
PPP Accountability Framework

1. Risk
2. Costs and Benefits
3. Social and Political
4. Expertise
5. Partnership Collaboration
6. Performance Measurements
Risk Structure

- A consortium company is often formed to optimize strengths
  - Design and build skills
  - Financial muscle
  - Distribution of risk
  - Construction vs. Operations phases
- The Private Sector will bear these risks:
  - Design and development
  - Construction
  - Cost overruns
  - Financing
  - Operations & maintenance
Risk Structure, continued

- Some risks logically stay in the Public Sector
  - Inflation
  - Government policy
  - Political risks
  - Planning approvals
  - Change in law
- Some risks can be shared between the Public and Private Sectors
  - 3rd Party Liability
  - Market risk
  - Force Majeure
  - Traffic volumes
Cost-Benefits

❖ Financial costs and benefits include both monetary expenditures and other gains and losses resulting from the partnership.

❖ Opportunity costs, or those costs associated with the alternative option of not entering the PPP, also should be identified.
Social and Political Impacts

❖ Consequences or improvements based on the results of the partnership may affect a variety of social and environmental systems.

❖ PPP impacts may be educational, health-related, legal and/or environmental in nature. In assessing impact, social equity affects, such as the differential impacts on socio-economic segments of society, should be considered.

❖ Inclusive stakeholder participation is needed to anticipate the distribution of social and environmental effects on different segments of society and different geographic areas.
Expertise

- The concept of expertise entails possession of the insights and skills needed, from both the private and public sectors, in order to assure success.

- It is important to have the personnel with the right abilities who are aware of and aligned with the objectives and mission of the partnership.

  “It is essential to involve personnel that clearly understand agency objectives and regulations as well as private business and contracting conventions” (U.S. Department of Transportation 2007).

- May include knowledge and skills in information technology, law, and management of public relations and internal partnership issues.
Partnership Collaboration

- The human connections that establish the interactions of a PPP affect the overall ability of an agency to monitor compliance and reward success or punish failure by the private partner.

- Challenges to consider, include:
  - effective leadership
  - communication with stakeholders
  - project management
  - trust
Performance Measurement

- Performance measurement can increase accountability to the public as well as encourage and codify shared commitments and responsibilities.

- Performance metrics can:
  - aid in establishing trust between workers with diverse orientations and backgrounds
  - help managers on both sides engage, assess and continuously improve organizational results
  - strengthen accountability in the partnership.