

## Critique of PPPs

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## 0. Introduction

This paper is one of three dealing with the subject of PPPs in Europe. It covers the problems experienced with PPPs and their role in EU law (EUPPPs-crit). The other two papers concern positive initiatives for the improvement of public services and strengthening of the role of the public sector, as alternatives to the use of the private sector (EUPPPs-altern), and ways in which trade unions in Europe have negotiated protection for their workforces (EUPPPs-barg).

This report is presented in six sections.

- Concept and definitions of PPPs
- Overview of development of PPPs in Europe
- EU laws and policies in relation to PPPs
- Myths about PPPs
- Evaluating PPPs – a framework covering cost of capital, construction costs, operating costs, transaction costs, and uncertainty
- The lessons of the Metronet failure in the UK

## 1. Concept and definitions

In the 1990s the phrase ‘public private partnerships’ (‘PPP’s’)it was adopted by governments and institutions such as the EU as a ‘softer’ alternative to the word ‘privatisation’, as a euphemism: “expressions such as “public – private partnerships” invite more people and organizations to join the debate and enable private organizations to get a market share of public service provision. It seems fair to say that a number of governments have tried to avoid using the terms “privatization” and “contracting out” in favour of speaking about partnerships.”<sup>1</sup>

At the same time a specific form of privatisation was developed to deal with limitations on public borrowing. This involved using a private company to borrow money, build a new hospital, school, road, etc, and then operate it over many years, recouping the investment and profit from payments over the whole period of operation. In the EU, in particular, these have become known specifically as PPPs. There are two forms of PPPs. Firstly, concession contracts, where the company gets paid by user charges – for example in water services, or toll roads. Secondly, contracts typical of the private finance initiative (PFI) in the UK, where the company gets payments from a public authority. Concessions can only be used where end-users are charged, whereas the second ‘PFI’ type of PPP can be applied to almost any element of public service, thus expanding the potential scope enormously.

This paper treats this as the ‘core’ concept of a PPP, which can be defined quite precisely as:

- a contract between government and a private company, under which:
- the private company is required to finance and build an infrastructure asset (road, school, software, kitchen), and subsequently:
- maintain the asset and, usually, operate some element of a public service, using the asset;
- in return for which the company is paid over a number of years for the cost of construction and the operation of the service, either through charges paid by users, or by payments from the public authority, or a combination of both.

Such contracts are also sometimes described as ‘Design, Build, Finance, Operate’ (DBFO) or ‘Build, Operate, Transfer’ (BOT)

There is also a further meaning of PPP, which the European Commission has called an ‘institutional PPP’. This is a joint venture company, providing a public service, which is partly owned by a public authority and partly owned by a private company or private investors. They may also have a contract with the municipality to provide a service – for example, in Italy, Hungary, the Czech republic and other countries some water operators are partly owned by the municipality, and partly by private companies, under contracts with the municipality to run the water services. These

joint ventures may operate public services without having had to compete for a formally tendered contract, especially where they originated as municipal companies, or where a service was 'delegated' without tendering.

## **2. Overview**

### **2.1. Growth of PPPs**

Although the phrase PPPs was little used before the 1990s, concession contracts have been used for many centuries. They were often used in the 19<sup>th</sup> century to develop water, gas, and electricity systems which involved high capital expenditure. The principle was that the private company agreed to invest its own money, in return for which the state guaranteed a monopoly to the company on supplying that service in the area covered, and so the company could expect to get a return on its capital by charging users. The same principle was used for toll roads, bridges, railways, etc. Concessions were unable to deliver the required scale of investment for universal services at affordable rates, and so were generally replaced by public ownership.<sup>2</sup>

Institutional PPPs have developed as a result of governments and regional or local authorities buying or selling shares in companies. France developed the concept of the 'societe d'economie mixte' (SEM), which allowed municipalities to set up trading companies, as long as there was a private company also involved. In Germany, Italy and elsewhere municipalities established their own companies to operate utility services. Many governments also developed partial (or total) shareholdings in manufacturing or service companies, with a fluid interchange between public and private ownership of companies in a number of sectors. The most significant recent trend has been due to municipal companies in Germany, Italy and elsewhere being partly or wholly sold to the private sector.

Following the collapse of communism, joint public-private ventures were frequently used as a way of introducing private companies into public services, for example in water in Hungary and the Czech republic.

The UK developed the use of PPPs under the heading of the private finance initiative (PFI) from the 1990s. This covers road and rail, hospitals, schools and other buildings. PPPs were also introduced in sectors which have not been privatised, such as water in Scotland and Northern Ireland.

Other EU countries also began using PPPs, following the Maastricht treaty which limited public borrowing. The EU itself has encouraged the development of PPP units in all countries to facilitate the creation of PPPs. By 2006 most EU countries were using or planning to use PPPs.

Other countries with similar policies introduced a range of similar measures. New Zealand, Australia and more recently Canada and the USA all began using PPPs in the strict sense as an element of privatisation policy. Donors, the development banks and multinational companies encouraged the spread of PPPs in developing countries from the 1990s. This was part of the general promotion of privatisation. The forms included concessions in water, IPPs in electricity, and toll roads.

### **2.2. Trends in PPPs**

#### **2.2.1. Relative importance of PPPs**

PPPs remain a small part of total public investment. The great majority is still carried using the conventional method of public sector finance, a separate construction contract, and services operated by directly employed staff or, in some cases, contractors under a simple outsourcing contract. According to a global survey by Siemens, PPPs only account for about 4% of all public sector investment: "Loan financing is widely expected to remain the key financing instrument across Europe."<sup>3</sup> Even in the UK, despite the scale of PFI/PPP operations, they have accounted

only for about 10-15% of all public sector capital investment since 1996, with the remainder being carried out through conventional forms of procurement.<sup>4</sup>

### 2.2.2. Countries and sectors

The value of all PPPs in Europe (excluding the UK) has risen sharply since 2004. A total of €31.6 billion worth of PPP projects had been signed by the end of 2006, of which €23.6bn. were signed in 2004-2006. The growth has continued even more sharply: at the start of 2007 there was €67.6 billion worth of projects in the process of procurement. Italy is much the largest market with projects to the value of €30bn being procured; of this €21.3bn relates to transport (roads, bridges and metro), €2.6bn to water projects, and €2.0bn to hospitals. Germany and Greece are the next largest countries for new PPPs in 2007, with €9.5bn and €6.3bn respectively.<sup>5</sup>

**Table 1. PPPs in Europe**

Table 5 PPP in Europe							
Value of signed contracts, €m 2001-06					Total	Number signed deals 2001-07	Projects being procured Jan 2007 €m
	2001-04	2005	2006	2007			
Spain	1000	1154	1664	309	4127	38	2931
Italy	890	2179	439	55	3563	20	29799
Ireland	720	121	623	1489	2953	18	---
France	0	1788	735	329	2852	26	3964
Greece	0	798	1600	3885	2398	7	6270
Germany	440	830	177	465	1912	34	9495
Belgium	1300	480	---	300	1780	5	3635
Netherlands	1302	---	431	---	1733	6	1211
Poland	1520	---	---	---	1520	2	1317
Austria	49	0	850	---	899	6	20
Finland	0	700	---	---	700	1	---
Bulgaria	0	366	288	366	654	6	2202
Cyprus	0	500	---	---	500	1	---
Portugal	278	---	32	140	450	6	1515
Other countries	488	2	528	15	1018	17	5221
<b>Total (exc.UK)</b>	<b>7987</b>	<b>8918</b>	<b>7367</b>	<b>7353</b>	<b>31625</b>	<b>193</b>	<b>67580</b>
UK	21849	6237	14111	10698	42196	501	

Source: Public Private Finance, DLA Piper

Source: IFSL (2008)

In European countries as a whole, transport infrastructure accounts for 82% by value of all completed, current and projected PPPs; 4% was defence; 4% healthcare; 3% sports and leisure; 2% education; 2% waste and water.<sup>6</sup>

In the UK, over half of all the PFI/PPP projects are in health, education and local government - much higher than in other European countries. Over a 20 year period in the UK, 23.2% by value of PFI/PPP projects have been in the health sector, and 15.5% in education, 11.7% in accommodation/housing, 4.2% in waste and water, and 1.5% in other local government services. The proportion in transport has dropped sharply, due to the failure and cancellation of the £5.5 billion London Underground PPP. This single failure represents nearly 10% of all PFI/PPP projects ever signed in the UK. (IFSL 2008).

**Table 2. PPPs/PFI in UK**

Table 4 UK PFI/PPP sector breakdown							
Signed projects, £m						Cumulative	% share
Sector	2003	2004	2005	2006	2007	1987-2006	1987-2006
Transport	442	457	403	292	497	16605	28.4
Health	707	2681	992	3020	1911	13848	23.2
Education	373	575	1146	2434	2415	9268	15.5
Accommodation	332	718	443	1455	616	6416	10.7
Defence	775	121	600	1800	1000	6021	10.1
Telecoms & IT	60	25	540	—	490	2672	4.5
Waste mgmt. & water	343	300	—	575	314	2537	4.2
Local government	361	295	98	—	—	910	1.5
Other projects	68	74	38	31	75	1118	1.9
<b>Total</b>	<b>3461</b>	<b>5245</b>	<b>4261</b>	<b>9607</b>	<b>7318</b>	<b>59745</b>	<b>100.0</b>

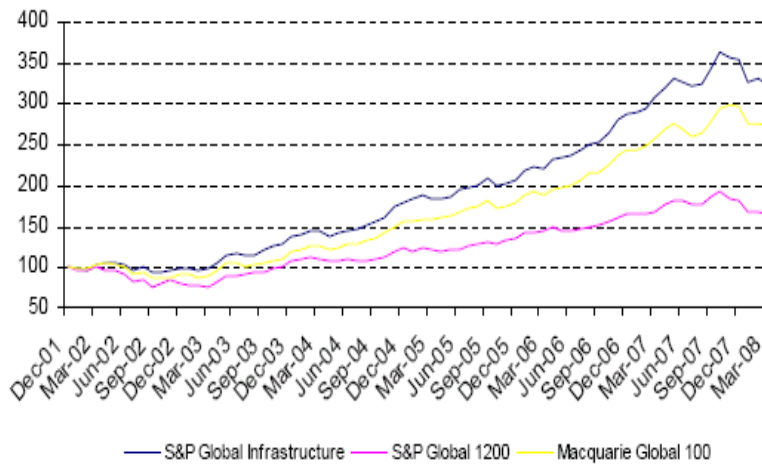
Source: Public Private Finance

Source: IFSL (2008)

**2.3. Companies**

PPPs have opened a large and profitable new market for many companies. The chart below shows a global index of the 75 largest companies investing in infrastructure, which accounts for the the largest proportion of PPPs, including water, energy, roads and rail. The value of shares in these companies increased by over 250% in 6 years to the end of 2007 – while the global average for all major companies was under 100%.

**Chart A. Infrastructure companies: double average growth since 2001**



Source: Standard & Poor's

A number of multinational companies have developed as multinational specialists in building and operating public infrastructure and services. These include companies with sectoral specialisms, e.g. in water and waste Suez, Veolia, and FCC; construction companies e.g. Hochtief and Bouygues; and a large number of banks and other financial institutions.

In the UK a number of PFI projects have been sold on to new owners, with financial companies increasing their dominance: "by March 2006 40% of operational [PFI] projects had changed ownership and in 50% of the cases of changed ownership the debt had been refinanced as well. The consolidation of ownership continued, despite levels of return on secondary holdings down to around 7-8 %"<sup>7</sup>

The financial institutions which are buying infrastructure PPPs include a group of specialist private equity firms operating so-called infrastructure funds. The largest of these is the Australian bank Macquarie. The underlying attraction of the investment is a reliable flow of cash from essential services or government-guaranteed payments, but these funds also extract exceptional profits through the payment of fees to the groups themselves. A report by financial analysts in 2008 showed that infrastructure funds frequently pay dividends to investors and fees to the financial institutions greater than the total profits made by the companies in which they have invested.<sup>8</sup>

### **3. EU law and policies in relation to PPPs**

#### **3.1. Introduction**

The rules, laws and policies of the EU have a significant effect on the use of PPPs. They can be divided into three main headings.

- EU rules on government borrowing, which creates incentives for PPPs
- European Commission policies of promoting and encouraging PPPs
- procurement laws, which affect how PPPs have to be created

#### **3.2. EU fiscal rules and PPPs/PFI**

The limits on government borrowing imposed by EU, national and IMF policies is the strongest explanation for the growth in PPPs. The EC itself commented in 2000 that interest in PPPs had grown: “due to budgetary restrictions and a desire to limit the involvement of public authorities”.<sup>9</sup>

The EU fiscal rules were introduced in 1996 as part of the Maastricht treaty, and forms part of what is known as the Stability and Growth Pact. The provisions are contained in the Consolidated Treaty and related documents: the relevant texts and references are set out in Annex 1. The Maastricht treaty stated that “Member states shall avoid excessive government deficits”, and that not having an excessive deficit was one of four convergence criteria for admission to European Monetary Union, and, later, adoption of the Euro. The “reference values” used for determining the maximum acceptable limits were defined as:

- “3% for the ratio of the planned or actual government deficit to GDP” and
- “60% for the ratio of government debt to GDP”.

These ratios cover the deficit and debts of “central government, regional or local government and social security funds, to the exclusion of commercial operations”. The EU definitions of general government include “institutional units producing non-market services as their main activity”, and so exclude public enterprises which operate commercially through charging for services.

These definitions differ from those used by the UK or the International Monetary Fund (IMF), both of which have included the borrowing of state-owned enterprises as part of general government borrowing. This difference creates different incentives. Under the EU rules there is no incentive to create PPPs as substitutes for investment by public enterprises, for example railways (where these remain in public ownership): borrowing by a state-owned railway would not be counted as general government borrowing anyway under the EU rules.

The EU rules do create an incentive for PPPs in government operations which are not carried out through trading operations, such as many health and education services, because they shift borrowing for capital investment from the government to the private partner. The rules therefore create an incentive to choose PPP financing in these services as an alternative to government borrowing, as a way of minimising government deficit.

Even here, however, there is an equal incentive for corporatisation. Transferring a government activity into a trading public enterprise also shifts the entity out of the general government category, and so reduces government borrowing in the same way as a PPP. And the EU rules make it equally attractive to create a ‘PPP’ with a partner which is a public enterprise, because that



partner's borrowing and debts are also outside the general government as defined by the EU, and so it achieves the same effect as a PPP with a private company. This is why the Eurostat ruling (see below) describes the PPP partner simply as a 'non-government unit', not as necessarily privately owned.

- **While the Maastricht rules create some incentive for using PPPs to reduce borrowing by public authorities, the same effect can be achieved within the public sector if the borrowing is transferred to a public enterprise.**

### 3.3. EU promotion and funding of PPPs

The European Commission has for many years pursued a policy of facilitating and encouraging PPPs. In 2003 it argued that PPPs should be used to develop trans-European networks, and so proposed: "to launch a major public consultation regarding the rapid development of various forms of PPP"<sup>10</sup>; in 2004 it issued a green paper on PPPs<sup>11</sup> which aimed: "to facilitate the development of PPPs under conditions of effective competition and legal clarity".<sup>12</sup> The EC has now created the European PPP Expertise Centre (EPEC), through which the EC and the European Investment Bank (EIB) "disseminate information and best practice for the benefit of Europe's public PPP task forces and provide policy and programme support in PPP procurement and management to its public sector membership".<sup>13</sup>

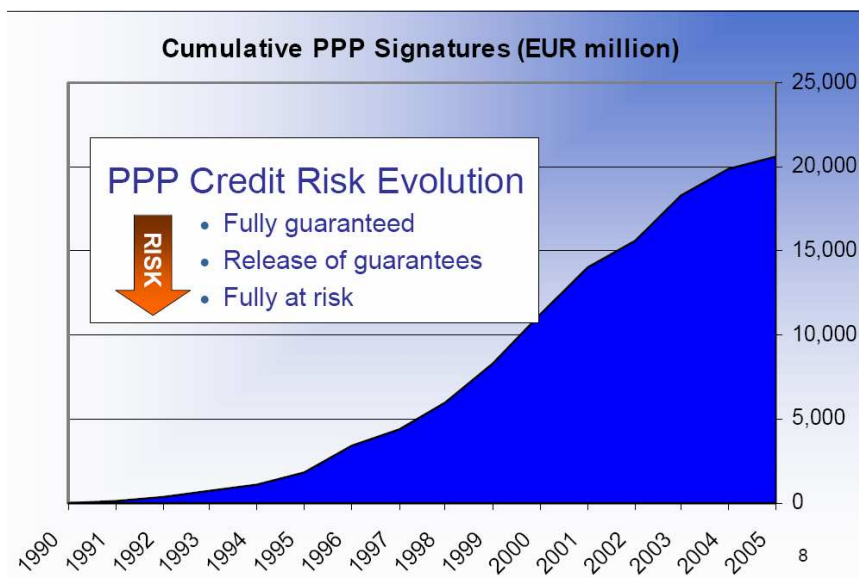
For the private sector, PPPs are a way of exploiting not only government procurement expenditure but also the cheaper finance available through the public sector. Apart from national and local governments, the EU itself is a major source of such public expenditure and public finance.

The private companies are well aware of the importance of this funding, as highlighted in a report by the consultancy/accountancy firm PWC in a 2005 report, which focussed on the value of:

- projects co-financed by the EU development banks, the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD).<sup>14</sup>
- direct EU public spending through finance for the EU trans-European transport networks (TENs);
- direct EU public spending through the EU Cohesion Fund, Structural Funds or ISPA

As public banks guaranteed by the EU and Member States, the EIB and EBRD can obtain the best interest rates available, which is a great advantage to the private companies financing PPPs. The EIB "is one of the biggest funders of PPPs, in a variety of sectors, including water, health and education", and 15% of all its lending in 2006 was for PPPs in transport alone.<sup>15</sup>

#### Chart B. EIB funding for PPPs



Source: Goldsmith 2006

There is a problem over the compatibility of EU funds with PPPs. EU rules make it difficult to allocate these funds to projects run by a private company, and so this acted as a disincentive for countries to use PPPs. The EU Court of Auditors in 2007 noted that “only a limited number of PPP-type projects have received EU grants.... like Athens' International Airport, the Vasco da Gama Bridge in Portugal, a few de-salting plants in Spain. ...The Court raised observations about structural problems affecting the [Vasco da Gama Bridge] project, weaknesses in the revenue forecasts as well as excess in the total EU contribution.”<sup>16</sup>

The EC has devoted considerable energy to producing guidance on how to solve this problem. In 2003 a guide was issued on “developing successful PPP projects in the candidate countries” so that they were compatible with the rules for providing accession funds, stating that “The European Commission has an interest in promoting and developing PPPs within the framework of the grants it provides”<sup>17</sup>, with a further guide in 2004 intended to demonstrate that “it is possible to successfully manage these constraints [of ISPA and cohesion fund rules] and integrate the needs of all parties”.<sup>18</sup>

In 2006 the EC, the EIB and the EBRD created a new institution to deal with this, the Joint Assistance to Support Projects in the European Regions (JASPERS). Publicly financed, JASPERS offers free advice on constructing PPP projects in such a way as to enjoy the maximum possible support from further public finance in the form of the cohesion and structural funds of the EC: “JASPERS will assist beneficiary countries (principally the new Member States and acceding countries of the EU) to prepare major infrastructure projects which will be assisted by the EU Structural and Cohesion Funds over the next budgetary planning period 2007-2013. All assistance will be offered free of charge. Assistance may be given to prepare individual projects or horizontal studies that cover more than one project or more than one country...Key areas for JASPERS include....Private public partnerships.”<sup>19</sup> According to the EBRD: “The key priority of JASPERS is the preparation of PPPs to help ensure that they are compliant and compatible with necessary regulations.” (EBRD 2007)

The EBRD has also criticised transition countries for not adopting laws more favourable for PPPs. The bank carried out a survey in 2005 and decided that many transition countries did not comply with ‘international standards’ for concessions. One of these ‘standards’ demands that the law should not require the use of a model concession agreement – despite the fact that this is regarded as an important protection for public authorities who lack the capacity to negotiate agreements from scratch. Another is that the country should always allow access to international arbitration – a condition which undermines national sovereignty and is expected to favour companies claiming compensation. Another is that the laws should provide for state guarantees for PPPs – despite the

fact that such guarantees mean that the private company carries very little risk. The EBRD rated 3 Member States as 'low compliance' with these international standards, as 'medium': it also found that "state financial support and guarantees rules were generally entirely omitted from the law or contained unnecessary restrictions." Most transition countries have now introduced legislation for PPPs and concessions, except Hungary.<sup>20</sup>

### 3.4. Fiscal discipline or PPPs?

There is a dilemma for fiscal rule-makers, such as the EU and the IMF, between enforcement of fiscal discipline – which would involve making stricter conditions for PPPs being acceptable – and a desire to promote privatisation in general, which would imply making it easier to use PPPs.

The EC has taken various different views on the relations between PPPs and fiscal discipline. The report on EMU in 2003 (produced before the Eurostat ruling) said: "there is the risk that the recourse to PPPs is increasingly motivated instead by the purpose of putting capital spending outside government budgets, in order to bypass budgetary constraints. If this is the case, then it may happen that PPPs are carried out even when they are more costly than purely public investment." (summary of part III, p.102).<sup>21</sup>

In October 2005, PPPs were again being treated as objects of suspicion:

"Monetary affairs commissioner Joaquin Almunia accused national governments of using "tricks" to artificially cut budgetary deficits, as Member States try to be seen to be following the Eurozone's rules.... He particularly referred to so-called Public-Private Partnerships (**PPP**), which share the financial burden of large infrastructure projects. According to Mr Almunia, it has become increasingly difficult for the EU executive, in charge of monitoring Member States' budgetary performance, to look through such tendencies and figure out the real height of the countries' deficits. ... The commissioner stressed that **Europe** should avoid the situation where public accounts imitate the creative accounting of some companies in the past."<sup>22</sup>

As these statements suggest, there was a lack of clarity over the circumstances in which PPPs are officially recognised as being outside the categories of public borrowing and public assets and debts that are constrained by the EU rules. This matters because private companies want to minimise their risks, whereas governments have to argue that risk has been transferred to the private partner in order to justify treating the borrowing as private.

#### 3.4.1. The Eurostat ruling

The dilemma was solved, for supporters of PPPs, by a ruling by Eurostat, the Statistical Office of the EC, in February 2004, that the assets involved in a PPP should be classified as non-government assets, and therefore recorded off balance sheet for government, as long as (a) the private partner bears the construction risk, and (b) the private partner bears either availability or demand risk.<sup>23</sup> This is an easy requirement – availability risk simply means that the private sector accepts responsibility if its own asset stops working at a time when it is needed. All the demand risk – the risk of the asset becoming obsolete or unnecessary due to changes in technology, for example, can remain with the government. The Eurostat ruling thus made it easy to create PPPs which shifted the debt off the government's balance sheet without creating any major risks for the private partner.

The IMF was unimpressed with this ruling, seeing this as an invitation to creative accounting to avoid the fiscal rules. In March 2004 it described the Eurostat decision as "problematic"<sup>24</sup>, declaring that the "recent Eurostat decision on accounting for risk transfer gives considerable cause for concern, because it is likely to result in most PPPs being classified as private investment. .... Since most PPPs involve the private sector bearing construction and availability risk, they will probably be treated as private investment, even though the government bears substantial demand risk (e.g., when it guarantees to the private operator a minimum level of demand for the service provided through the PPP). ...the recent decision .... thus could provide an

incentive for EU governments to resort to PPPs mainly to circumvent the Stability and Growth Pact (SGP) fiscal constraints.”<sup>25</sup>

The ruling still leaves considerable uncertainty over the classification of PPPs. For example, it remains unclear how to account for contingent liabilities which governments may incur as a result of guarantees to PPPs. In 2007 the official review of EU finances commented that: “the distinction between debt and this ... definition of implicit liabilities is often a matter of convention rather than of substance. Some government obligations in relation to partnerships with the private sector, e.g. regular payments to private enterprises managing infrastructure, such as motorways, could also be considered in this ... definition of implicit liabilities.”<sup>26</sup>

The uncertainty is such that Eurostat rulings on PPPs have had a serious impact on a major issue of macroeconomic policy, namely the entry into the Euro zone of member states who joined in 2004. In 2005 Hungary set up a motorway PPP scheme which it treated as private borrowing, which would have allowed the public finances to remain within the required limits for adopting the Euro; Eurostat however ruled that the scheme should be treated as increasing government debt, and so Hungary’s accession to the Euro would be delayed.<sup>27</sup> In 2008, Slovakia is waiting for Eurostat to make similar rulings in respect of state media companies, motorways, and public hospitals: again, the decisions could affect the date of adoption of the Euro in Slovakia.<sup>28</sup> The UK is experiencing similar uncertainty in relation to its PFI schemes, as the National Statistical Office

### 3.4.2. International accounting uncertainty: IFRIC 12

There is further uncertainty because international financial reporting standards (IFRS) now recommend that asset ownership in service concessions should be decided on the basis of effective control, not risk transfer, a recommendation enshrined in a note known as IFRIC 12.<sup>29</sup> This is expected to force governments to treat PPPs as public debts after all (although the European Commission has said that it should not affect current practices in accounting for PPPs ‘off balance sheet’<sup>30</sup>). In Estonia, for example, “international reporting standards may force local governments to put projects on balance sheet, which would make it impossible for the great majority of municipalities to carry them out.”<sup>31</sup> In the UK, it is generally expected that many or most PFI schemes will now appear as government debts: “Under this, many PFI-funded assets will, for the first time, form part of NHS accounts, treated as if they were finance leases;”<sup>32</sup> “Ifric 12 makes it clear that PFI investments will not score on the private sector’s balance sheet.”<sup>33</sup>

- **Despite the Eurostat ruling, and the attempts to make PPPs compatible with the rules for EU aid, PPPs may remain vulnerable to challenges on the grounds that there has not been a proper transfer of risk, or that the government still remains liable for the debt, especially in view of the new international accounting rules which use the criteria of ‘control’ to decide who owns an asset.**

### 3.5. EU procurement law and PPPs

EU procurement laws do not fit simply with PPPs. There are three different categories.

Firstly, some PPPs are concessions, which are technically exempt from the procurement directives, although they are still subject to the competition and transparency rules of the Treaty.<sup>34</sup> The EC now proposes to issue a new communication.

Secondly, many other PPPs, where the contractor is paid by the public authority, are not concessions. Since they are contracts, they must all be subject to competitive tendering under the procurement directives. This has created problems, as many PPPs were signed without any competition, and a number have been ruled illegal as a result (see below).

The third category is of companies which are jointly owned by public authorities and private shareholders, known as ‘institutional PPPs’. A new communication has been issued on these, which effectively requires competitive tendering to create such a joint venture.

### 3.5.1. EC guidelines on institutional PPPs

In February 2008 the EC published its interpretative Communication on institutional PPPs.

- Commission Interpretative Communication on the application of Community law on Public Procurement and Concessions to Institutionalised Public-Private Partnerships (IPPP) C(2007)6661 Brussels, 05.02.2008 [http://ec.europa.eu/internal\\_market/publicprocurement/ppp\\_en.htm](http://ec.europa.eu/internal_market/publicprocurement/ppp_en.htm)

Its overriding concern is not to clarify the status of publicly owned companies with a proportion of the shares held by a private investor, but to remove uncertainty that might deter the creation of IPPPs: "The Communication aims at enhancing legal certainty and, in particular, assuaging repeatedly expressed concerns that applying Community law to the involvement of private partners in IPPP would make these arrangements unattractive or even impossible." It is thus another instrument aimed at facilitating PPPs. (p.2)

The communication defines IPPPs as involving a joint venture in which the private partner plays an active role in managing the activities: "a cooperation between public and private parties involving the establishment of a mixed capital entity which performs public contracts or concessions. The private input to the IPPP consists – apart from the contribution of capital or other assets – in the active participation in the operation of the contracts awarded to the public-private entity and/or the management of the public-private entity." (p.2)

The communication states that IPPPs must always be the subject of tendering, but that this needs only be done once: an IPPP can be created and awarded a package of work by a single act of tendering under public procurement rules. It further states that IPPPs "must remain within the scope of their initial object and can as a matter of principle not obtain any further public contracts or concessions" without competitive tendering. It remains possible for the terms of an IPPP to be varied without further tendering so that it can "adjust to certain changes in the economic, legal or technical environment" – thus allowing re-negotiations of contracts to

The communication notes the rulings of the European Court of Justice (ECJ) that even a very small private minority holding can prevent an entity from being treated as an inhouse operation, but claims that this depends on the existence of an intention to open the capital of the entity to private parties. It even argues that there is "theoretical possibility of a private party participating in the capital of a public authority's subsidiary" which might not affect inhouse status, and so that: "simple capital injections made by private investors into publicly owned companies, do not constitute IPPPs." (p.4, footnote 14; p.2)

This communication allows the ECJ to continue to rule that even an operation which is wholly owned by a public authority may not be regarded as an inhouse operation if the ECJ considers it possible that the entity could at some future point be partly sold to a private partner. This in turn seriously undermines the theoretical right under the treaty for a public authority to choose an inhouse option without being forced to invite competitive tendering. Public authorities may be unwilling to work through wholly owned bodies without tendering, if they risk a court case which would result in a ruling that the entity has to compete for its work in any case.

- **PPPs remain subject to procurement rules requiring competitive tendering, but officials and politicians may still attempt to negotiate deals without normal tendering procedures. National courts may rule such PPPs illegal due to a failure to carry out proper tendering.**

### 3.5.2. Uncertainty over inhouse operations

The EC may have made it easier to create IPPPs with confidence, but it has made it even harder to create or maintain inhouse entities. The relationship between procurement rules and inhouse operations remains unclear. A series of judgments by the ECJ concerning the inhouse exemption from competitive tendering has created great uncertainty, especially for corporatised 'arms-length' entities.

- The Arnhem judgment ruled that if there is competition from private companies to provide a service, then a municipally owned entity providing that service must be regarded as a commercial entity, not as a public law body pursuing public service objectives, and so could not be awarded contracts without open competitive tendering.<sup>35</sup>
- The Teckal judgment ruled that an organisation can only be assigned work without competitive tendering if the public authority exercises over it: “a control which is similar to that which it exercises over its own departments” – and if the ‘essential’ part of its work is for the public authority.<sup>36</sup>
- The Parking Brixen case ruled that an organisation could not be treated as an inhouse entity, even if it was 100% owned by the municipality, if there was a possibility that the municipality might sell some shares to a private investor and thus lose control<sup>37</sup> (the Stadt Halle case had already ruled that even a minority private shareholding makes it impossible for an entity to be treated as an inhouse operation<sup>38</sup>).

The effect of these rulings is that public sector organisations are treated increasingly like private contractors or PPPs. It becomes increasingly difficult to make the policy choice to have an inhouse service rather than a PPP or private contractor. Public authorities are under pressure to invite tenders for all work, with their own public sector organisations treated as just one contractor amongst others. This recreates the ‘compulsory competitive tendering’ which was introduced by the Thatcher government in the UK - but which was abolished in the UK over 10 years ago.

This has been described as a “conflict between the competition and internal market rules of the European Union and the rights and the room for manoeuvre of the Member States and their subordinate territorial authorities in the area of public services”. It is especially damaging in countries such as Germany where many local services are carried out by a large number of public sector organisations with various legal forms. These public sector companies are often legally barred from bidding for work outside their own locality, and are disadvantaged compared with commercial contractors, who are allowed to cross-subsidise within their own companies, and are able to form informal oligopolies to squeeze out public sector operators.<sup>39</sup>

- **There are a number of initiatives at EU and national level to call for the development of EU law to recognise the important role of public services and the the principle of subsidiarity (e.g. through a EU legal framework for services of general interest.)**

### 3.5.3. Inter-municipal organisations and public-public partnerships

The interpretation of procurement law by the ECJ has also damaged another widespread form of public sector cooperation. Inter-municipal organisations are common in Europe. They enable municipalities to cooperate and take advantage of economies of scale, for example in services such as water, waste management, or public transport. They may take the form of a public authority to which the municipalities delegate powers, or of a company or a joint venture owned by the municipalities.<sup>40</sup> Other forms of collaboration between public authorities – sometimes called ‘public-public partnerships’ - are also used as a way of improving efficiency through cooperation and shared resources.<sup>41</sup> Public authorities have traditionally treated all such collaborative relations between themselves as a broader form of direct provision by the public sector, and therefore exempt from the need for competitive tendering.

Successive decisions by the ECJ have threatened these practices. The EC in turn has taken proceedings in a number of cases against Spain, France, Germany and Italy, prompted by complaints from private contractors. Both the court cases and the EC proceedings argued that the provision of services by municipalities to such organisations, or vice versa, are contracts which should be subject to competitive tendering.

- In Spain, the EC won a court ruling from the ECJ that national laws could not exclude co-operation agreements between municipalities from the procurement directive’s requirements for competitive tendering.<sup>42</sup>

- In France, the EC has stated that if a municipality provides services to an inter-municipal association, then this must be treated as a public contract and be opened up to competitive tendering.<sup>43</sup> The general code for local authorities has to be changed to prevent such arrangements without competitive tendering.
- In Italy, the EC states that a consortium of Italian municipalities in the Ancona region cannot award a water and wastewater contract to a company jointly owned by the same municipalities without opening it for competitive tender.<sup>44</sup>
- In Germany, a group of 3 local authorities - Heidelberg, Mannheim and Rhine-Neckar - have cooperated in waste management for over 20 years by agreeing that each one will specialise in one aspect of the service, and all 3 authorities will use each other's resources for the appropriate service. The EC has ruled that all these contracts must be opened for competitive tender.<sup>45</sup>

There is a conflict between the approach behind these decisions and the public service policies of member states, which the Commission acknowledges: "From a political point of view, the application of EC public procurement legislation to inter-communal cooperation might indirectly influence the incentives faced by local municipalities to engage in certain forms of cooperation, and hence raises a question of subsidiarity.....In general, Member States do not consider the creation of inter-communal cooperation as an activity subject to tendering procedures. This however, does not completely match the position of the Commission.." <sup>46</sup>

The EC claims that "tendering ensures that they get best value for their citizens' money", but such rulings and proceedings clearly prevent municipalities from having the flexibility to adopt the most efficient form of organisation in providing direct services. Such flexibility is a major advantage of the public sector, and has been used to provide an efficient public sector service without incurring the transaction costs of tendering and contract management.

The EC is insisting that the judgment of local democratically elected authorities must be subordinated to the central principle that competitive tendering is always best. The result is to actually deter authorities from the most efficient arrangements: "whilst collaboration between local authorities or within the public sector may appear to be a sensible, practical cost effective way of delivering front line services, harnessing benefits of economies of scale, saving money and making the back office more efficient, public bodies will have to consider very carefully whether they need to comply with procurement law before simply entering into such arrangements with other like minded authorities."<sup>47</sup>

- **A petition was launched in the European parliament in February 2008 for the recognition at EU level of the legitimacy of the role of intercommunal organisations. The Committee of the Regions was also expected to support this petition.** <sup>48</sup>

#### 4. Claims and myths about PPPs

The central question about PPP proposals is whether they provide a way of financing and running public services which is better for the public and the services. These issues are dealt with in detail in section 5.

But first it is necessary to deal with four claims made by supporters of PPPs, which are supposed to demonstrate their superiority without considering their impact on costs, efficiency, effectiveness, service provision and value for money. These four key claims are: firstly, that there is no alternative to PPPs; secondly, that PPPs allow public money to be spent on other things; thirdly, that governments are relieved of risks, which are transferred to the private companies; and fourthly, that the private sector is intrinsically superior at delivering goods and services.

##### 4.1. 'There is no alternative'

The first argument offered for PPPs is that 'there is no alternative'. Governments claim that, because of the constraints on government borrowing, and a reluctance to increase taxes or

charges, projects such as new schools and hospitals could not go ahead at all without PPPs. This argument is used to support the assertion that PPPs are necessary, and also to dismiss the need to show value for money - because there is no alternative with which they can be compared.

Thus an evaluation of EIB loans to ten different PPPs across Europe “found that the key impact of the PPP mechanism was that the projects were implemented at all. In all of the projects evaluated in-depth, public-sector budgetary constraints meant that the alternative to a PPP project was **no** project, or at least no project within the foreseeable future, rather than a public-procurement project.”<sup>49</sup>

But the ‘budgetary constraints’ on government borrowing are political decisions, not set in stone. As the EIB evaluation notes, “The extent to which government spending limits could have been adjusted to accommodate these projects [without using a PPP] can be debated...”. Many countries have even undertaken borrowing which breaches the Maastricht rules: in 2006, 8 out of the 13 countries using the Euro had a deficit greater than the rules allowed, even after adjusting for fluctuations in the economy. When five countries exceeded their deficits in 2003 to 2005, the EC was unable to impose sanctions, and had to revise its rules to allow for longer adjustment. All of the countries which have breached the limits on borrowing since 2002 still have government debt greater than 60% of GDP, which is the limit under EU rules. Breaches of the rules continue, and a recent analysis published by CESifo, a leading economics institute, expects that: “when difficulties arise again, we will see renewed attempts by governments to test the limits of the new Pact, or to change the rules, instead of making the necessary adjustments”.<sup>50</sup>

The financial crisis of 2008 has now shown how budgetary constraints do not prevent policy decisions in favour of public spending. Governments everywhere are increasing their spending and borrowing in order to support the financial sector and the economy in general. The scale of this is far greater than investments raised for public services through PPPs. **The nationalisation of one failed bank in the UK (Northern Rock) in 2008 increased the UK national debt by £87billion – a figure greater than the combined total value of all the PPPs and PFIs ever signed over the last 13 years in the UK (£60billion) and the whole of Europe (€32billion, equivalent to £26billion).**<sup>51</sup>

The same is true of taxation. Governments constantly adjust taxes, and often increase them, even in periods of economic difficulty. For example, in September 2008 France increased taxes on capital by over 1%, generating €1.5billion per year to fund a social initiative<sup>52</sup>; the Netherlands passed a new law increasing taxes on hedge funds and on companies paying excessive bonuses to company directors, raising €60m per year;<sup>53</sup> Hungary was considering a new tax on energy companies, expected to raise €177million, as were other countries, including Slovakia and the UK<sup>54</sup>.

#### 4.2. Saving public spending

The second key assertion is that PPPs are better because somehow they do not cost the public, or the public sector, anything. This myth takes various forms: the idea that the public – or the public authorities – do not have to pay for schools or hospitals developed by PPPs; the idea that the government or municipality will have more money left to spend on other services; and the idea that PPPs mean a reduction in borrowing.

But in PPPs like hospitals or schools, the government pays for the cost of the PPP from taxation – by paying for the cost of construction, and then the cost of running the service. So PPPs are paid for by the public sector in just the same way as projects carried out directly by public authorities.

The same applies to concessions where the PPP is financed by user charges. The cost of construction and operation are still paid by the users in the same way under a PPP as under direct public provision.

In both cases, money is borrowed from the same financial institutions - banks, pension funds and other investors. PPPs do not open access to special ‘new’ sources of finance. A PPP can spread



the cost of a new building over many years, like any form of borrowing. But it does not reduce the overall cost of e.g. building a hospital: it just spreads it into the future, and increases the cost because of the interest to be paid.

Over the lifetime of a project, it is very likely that a PPP will involve higher public spending than a conventional project, because of the higher costs of capital (see below). So the alternative of a conventional public sector project with an inhouse service would probably involve less public spending overall.

**Table 3. Myths about PPPs**

Does the PPP reduce public spending, government subsidies, or user charges?	No. The public authority, or users, have to pay for the cost of building and the service whether it is done through a PPP or through the conventional option.
Does a PPP mean that the private company pays for the cost of building?	No. The cost of constructing the building has to be paid for out of public spending or user charges. The private company just borrows money – but the public have to repay that loan, with interest.
Does a PPP reduce the cost of running the service?	No. The cost of running the service is paid for out of public spending or user charges. And empirical evidence shows that private companies are usually no more efficient than the public sector – and a PPP usually costs more to set up and manage.
Does it allow the government to spend more money on other services?	No. The public authority has to spend at least as much on the PPP as it would on the conventional option – so it may even have to cut other services.
Does the PPP reduce borrowing?	No. The same amount of money has to be borrowed to pay for the construction of the building- or even more, because PPP construction costs are usually higher..
Does the PPP reduce government borrowing?	Yes –if statisticians agree that it can be treated as ‘off-balance sheet’. But there is increasing uncertainty about whether PPPs can be treated as truly private borrowing.

#### 4.3. Risk transfer

The notion of ‘risk transfer’ plays an important role in justifying PPPs. Firstly, the transfer of risk is a key element in Eurtostat’s definition of what borrowing falls off a government balance sheet. Secondly, it has been used, especially in the UK, to justify use of PPPs which could not demonstrate that they were better value than a public sector option.

But transferring risk is not free. It is possible to write contracts which transfer the risk of construction delays to the contractor, for example – but these contracts cost about 25% more than conventional contracts (see below). It may not be worthwhile for the government to pay extra for such risk transfers. An economic analysis of risks and PPPs concluded that it is most efficient for demand risk to remain with governments, rather than the private sector, even if a PPP is used – and so it would be a waste of money to pay for this risk to be transferred to the private sector.<sup>55</sup>

The IMF has warned that governments may exaggerate the true value of risk transfer: “it is also possible that the government overprices risk and overcompensates the private sector for taking it on, which would raise the cost of PPPs relative to direct public investment”<sup>56</sup>. This seems to have happened in the UK. The table shows how major hospital PFI projects looked worse value than the public sector option until an estimate of ‘risk transfer’ was introduced. But no attempt is made to monitor if this risk transfer happens in reality, or how much benefit it really brings – out of 622 PFI contracts signed up to 2007, only 10 had been the subject of audited by the National Audit Office, and only 3 of these had examined the value of the risk transfer achieved.<sup>57</sup>

**Table 4. Risk transfer: making PPPs look better value**

	Public sector option	'Risk adjustment'	PFI/PPP option	'Risk adjustment'	Without 'risk adjustment'	After 'risk adjustment' PFI cheaper than public sector option
	Cost		Cost		PFI more expensive than public sector option	
Carlisle hospitals	151.1	21.8	167	0	+10.5%	-3.4%
North Durham	157.3	23.6	173.9	3.1	+10.6%	-2.2%
South Buckinghamshire	161.6	7.6	163.3	-1.7	+1.1%	-4.5%
Norfolk and Norwich	1598.2	83.7	1634.3	8	+2.3%	-2.4%
Dartford and Gravesham	900.1	43.8	921.1	1.4	+2.3%	-2.3%

Source: Froud 2003<sup>58</sup>

#### 4.4. The superior performance of the private sector

The final claim is that the private sector is more efficient in all areas than government and public sector employees. It is assumed that private companies can finance investment more cheaply and easily, and operate a service more efficiently, than the public sector.

These assumptions are false. It is not true that the private sector does or could borrow money for investment more cheaply than the government. The opposite is true, in almost every country in the world: governments can borrow money more cheaply, at lower rates of interest, than the private sector. And empirical evidence shows that the private sector is not overall more efficient than the public sector. Both these points are addressed in greater detail in the following sections

Nor are PPPs particularly successful at financing capital expenditure for the infrastructure of essential services. A World Bank research paper in 2006, reviewing actual private investment in a 22 year period from 1983 to 2004, concluded bluntly that: "PPI [private participation in infrastructure] has disappointed - playing a far less significant role in financing infrastructure in cities than was hoped for, and which might be expected given the attention it has received and continues to receive in strategies to mobilize financing for infrastructure...PPI is inherently limited in scope for financing urban infrastructure for the wide array of non-commercial infrastructure services cities need. Even for commercial services like water supply, subsidies are prevalent all over the world...Local governments need good sources of public finance to fund those services, and some form of government borrowing is needed for major investments in these areas to avoid inter-generational inequities."

In all cases, the expenditure of public money needs to be justified by expected improvements in the general economic and/or social well-being of the country or region. No PPP can ever be justified only by reference to the profits made by the private company.<sup>59</sup>

## 5. Evaluating PPP proposals

This section sets out a framework for evaluating whether any PPPs is preferable to a 'conventional' public sector approach. In every case – contrary to the claim discussed in the previous section – there is such a public sector alternative based on the government or municipality borrowing money (or raising taxes, or making a profit); issuing a conventional contract for constructing the desired hospital, school, road etc., and then operating it by directly employed staff. Under this alternative, the costs to the public are the cost of repaying the public sector loan, with interest, and the cost of employing staff and buying necessary equipment.

### 5.1. Public sector comparator

The evaluation of a PPP must therefore always be a comparative exercise. As the IMF insists: “When considering the PPP option, the government has to compare the cost of public investment and government provision of services with the cost of services provided by a PPP”<sup>60</sup> In practice, PPPs rarely carry out such a comparison – and therefore fail to demonstrate that they are better value for money. Sometimes a comparison is made using a notional ‘public sector comparator’, rather than a real public sector alternative proposal, but public auditors in the Netherlands and elsewhere have questioned whether such comparators are adequate.<sup>61</sup> A real comparison is important to avoid the use of PPPs simply as a way of moving borrowing off the public sector balance sheet, even when they are more costly.<sup>62</sup>

Some PPP assessments only consider whether the PPP is economically feasible for a private consortium.

For example, a state audit office report in Estonia has said that Estonian public authorities do not use proper public sector comparators in assessing the relative attractions of PPPs. The consequences of a PPP have been assessed “by primitive investment accounting, measuring the benefits in terms of cost savings and profits”. As a result “non-transparent, costly and unfavourable contracts” have been signed. These contracts have included inflated costs, due to excessive profit margins, risk premia, or depreciation allowances. Proper evaluations would have led to many PPPs being rejected: studies in Estonia have shown that long-term PPPs cost 25% more than public ownership. In addition to an accurate assessment of relative costs, a full public sector comparator needs also to assess the impact of a PPP on the mission and objectives of the public service, the economic effects – for example on employment, or the fiscal impact on public authorities – and the relative willingness to pay of citizens. There are multiple public interest objectives which need to be taken into account: a purely commercial comparator is not sufficient for this.<sup>63</sup>

The same problems have been highlighted in a new report on PPPs in the health sector in Italy. The report found that “Italian health-care trusts.... neither drew up any calculation for weighting their future costs and revenues related to the project, nor did they consider the social consequences for the community. They merely followed the legal requirements and prepared a financial plan from the private partner perspective. In deciding to create a PPP it is expected that public authorities would make the decision by reference to criteria of public benefit and by evaluating alternative ways of delivering the expected produce. The methodologies actually adopted e.g. in Italian healthcare PPPs, focus almost exclusively on the private sector perspective, namely ensuring that the PPP is structured in a way that makes it most likely to be financed at good (low) interest rates by banks. Limits on public borrowing constrain the possible alternatives, and in some sectors a small number of companies may have close relationships with each other and public authorities that make competition between private companies less likely.”<sup>64</sup>

- **comparison with a real public sector alternative should be required**

### 5.2. Framework for evaluating PPPs

The framework is a simple one, based on the economic elements of a PPP – finance, construction, and operation, and the contract itself. The first heading of evaluation is to compare the costs of capital finance for the PPP proposal and for the public sector alternative; the second is to compare the cost of construction; the third is the comparative efficiency of operation; the fourth looks at the comparative costs associated with setting up and monitoring a PPP contract; the fifth compares the uncertainties involved in such contracts.

This framework is similar to the Ryrie rules which existed in the UK, even under the Thatcher government, which required a straightforward comparison to demonstrate the superiority of a private finance option. **No private investment project ever met these criteria** – and so the private finance initiative (PFI) was invented, with new rules giving an advantage to the private

sector.<sup>65</sup> It also reflects the recommendations of the Estonian audit report (see 5.1, above) which recommended evaluations taking account of the range of public interests and objectives.

These comparative evaluations should be carried out on any PPP proposal before it is implemented. If the result is that the PPP looks like a worse option, then the public sector alternative should be preferred. The following subsections present some of the general evidence available on these comparisons.

**Table 5. Framework for evaluating PPP proposals against public sector alternative**

			Evidence	Note
1	Cost of capital	Interest + dividends	PPP more expensive	Private sector has to pay higher interest rates than government
2	Cost of construction		PPP more expensive	Higher cost of 'turnkey' projects, offset by saving on cost of overruns
3	Cost of operation	Efficiency	Neutral	Empirical evidence suggests no significant difference
4	Transaction costs	Preparation and tendering	PPP more expensive	Costs of preparing contracts and tenders
		Monitoring	PPP more expensive	Costs of monitoring and supervising contractors
5	Uncertainty	Renegotiation and contingent liabilities	PPP more risky	Future renegotiations and changes

### 5.3. Cost of capital

Governments can nearly always borrow money more cheaply than private companies or private individuals. This is because there is very little risk of defaults. Governments are always there, with large tax revenues; whereas no private company is immune from the risk of going bankrupt. Lending to private companies is therefore more risky, and so the interest rate is higher. The highest risk of all is attached to shareholders' investments in companies – known as 'equity' – because if a company fails the shareholders are the last to be repaid. As a result, shareholders expect the highest return on their capital, through dividend payments.

This can be seen in any empirical study of comparative costs of capital finance. For example, a study of PFI projects in the UK, carried out by PricewaterhouseCoopers, found that the average cost of private capital in the PFI schemes was 7%, whereas the cost of capital for buildings directly owned by the NHS was only 3.5%.<sup>66</sup> A detailed study of the cost of capital in the UK over the whole the 20<sup>th</sup> century, concluded that the long-term average cost of private equity is around 5.5%-7.5%, whereas the 'risk-free' rate (typically of government bonds) is about 2.5%.<sup>67</sup> These figures are broadly in line with other estimates.<sup>68</sup> In the USA, public sector borrowing costs 35% less than private borrowing.<sup>69</sup>

**This means that any PPP always starts with a handicap of higher costs of capital – which can only be offset by lower operating costs, i.e. greater efficiency – as stated by papers from the OECD, the IMF, and the leading FT commentator on globalisation.**

#### **OECD 2008 3.2.1 Box 7 – Efficiency gains and differences in public and private sector interest rates**

"....Though the private partner may have improved efficiency, the cost of capital of the private partner is usually higher than that of government, i.e. the interest rate on private sector loans usually exceed the interest rate on public sector loans. Thus, for the net benefit of a PPP to exceed the net benefit of traditional procurement, the efficiency gain of the private sector must exceed the additional interest cost that private partner pays compared to what government would pay in the case of traditional procurement. If the efficiency gain falls short of the additional interest cost, the minimum unit price at which the private partner can deliver the service will not be lower than the price government will pay in the case of traditional procurement."<sup>70</sup>

**IMF 2004 para 22.** ".... The government's power to tax reduces the likelihood that it will default on its debt, and the private sector is therefore prepared to lend to the government at close to the risk-

free interest rate to finance risky projects. This being the case, when PPPs result in private borrowing being substituted for government borrowing, financing costs will in most cases rise even if project risk is lower in the private sector. Then the key issue is whether PPPs result in efficiency gains that more than offset higher private sector borrowing costs.”<sup>71</sup>

**Martin Wolf, Financial Times, 12 June 2008-06-19** “...it seems obvious that the finance of assets is a suitable function for the public sector, which has one huge advantage - the ability to borrow cheaply. The difference between public finance of the assets and debt finance of a privately owned regulatory asset base, whose service is guaranteed by charges on customers set by a publicly appointed regulator, is, to put it mildly, not obvious. The most sensible solution would have been for the public sector to finance the assets....”

#### 5.4. Construction costs

It is frequently argued that the construction stage of PPP projects is invariably completed on time and within budget, and that this is a crucial advantage of PPPs over conventional public sector projects. The UK government claims that 76% of PFI projects are completed on time, compared with only about 30% of traditionally procured projects. A review of EIB funded PPPs across Europe also found that the projects evaluated “were largely completed on-time, on-budget and to specification.”<sup>72</sup>

But the construction element of PPP projects is much more expensive. An EIB report compared the cost of PPP road projects across Europe with conventionally procured road projects, and found that the PPPs were on average 24% more expensive than the public sector roads.<sup>73</sup> In 2007 the Polish government cancelled a motorway PPP for exactly this reason: they realised that the A1 Motorway from Grudziadz-Torun could be built for about €5.6m. per kilometre using conventional procurement, compared with €7.4m. per km. using the PPP.<sup>74</sup> The EIB report also notes that this premium of 24% is about the same as estimates of cost overruns on public procurement projects, and so the extra cost of PPP projects reflects the payment required by the contractor to accept construction risk.

This is achieved by “the use of fixed-price, fixed-term turnkey construction contracts” which make the building contractors responsible for any delays. The certainty of completion is achieved as a result of the contractor accepting responsibility for a wider range of risks, and contractors have to be paid more for doing this.

Why are turnkey contracts used in PPP projects when they are rarely used in conventional public sector projects?<sup>75</sup> The key reason is not because governments have decided it is worth paying more for higher standards of punctuality for public service infrastructure, but for the benefit of the PPP financier. As the International Federation of Consulting Engineers (FIDIC) notes: “Among such [turnkey] projects can be found many projects financed by private funds, where the lenders require greater certainty about a project’s costs.... Often the construction project is only one part of a complicated commercial venture, and financial or other failure of this construction project will jeopardize the whole venture.”<sup>76</sup> The private financier in a PPP project requires greater certainty about completion date, because the returns on investment only begin when the building is completed. And so the financiers benefit from the certainty of turnkey projects - but it is the public authority which has to pay extra for this certainty.

One other reason for using turnkey contracts is the Eurostat ruling which states that it is essential to transfer construction risk for it to be possible to classify the debt as private – off the government’s balance sheet. This risk thus has to be transferred, despite the extra cost,

- **the extra costs of construction under PPPs should be included in any comparative evaluation.**

## 5.5. Efficiency

As noted in the section on costs of finance, the private sector has to demonstrate greater efficiency – not just in theory, but sufficiently large and certain to offset the large and certain extra cost of private capital.

Empirical evidence from a number of studies shows no such pattern however – public operators are as likely to be more efficient as private operators. **So in evaluating PPPs there cannot be any general assumption of superior private sector efficiency – the assumption should be of neutrality.**

The evidence comes from a range of economic studies in public service sectors. A global review of empirical evidence on efficiency of public and private utilities in 2005 by the World Bank concluded: “For utilities, it seems that in general ownership often does not matter as much as sometimes argued. Most cross-country papers on utilities find no statistically significant difference in efficiency scores between public and private providers. As for the country specific papers, some do find differences in performance over time but these differences tend to matter much less than a number of other variables.”<sup>77</sup> Some studies found that the public sector was much more efficient: an early study in the USA in the 1970s found that private electricity companies had consistently higher costs, and that private firms charge higher prices.<sup>78</sup>

Studies in other sectors also find that there is no systematic efficiency difference. A study of cities with different types of bus operators found that the most efficient cities were equally likely to be public or private (Pina and Torres 2006).<sup>79</sup> Even in telecoms, a sector where the private sector is assumed to be performing better than the public sector could, a global study comparing private and public companies found that there was indeed “efficiency growth following privatizations” - but “it is significantly smaller than growth in public sectors.” (Knyazeva, Knyazeva and Stiglitz 2006)<sup>80</sup>

The same results emerge from studies of PPPs in the UK. A study of the use of PPPs in defence in the UK concluded that PPPs do not necessarily lead to efficiency gains and that there are significant costs and disadvantages: “The conclusion of the analysis is that the use of PPPs will not necessarily lead to improved economic efficiency in defence procurement and that considerable care will need to be taken both in terms of negotiating PPPs, monitoring their performance, and in their renewal. The UK defence sector illustrates that PPPs involve significant transaction costs which must be set against any benefits in terms of economic efficiency incentives”<sup>81</sup>. A similar result emerged from a study of PPPs in the health and municipal services sectors in the UK: “a vicious circle of monitoring and distrust between partner organizations, in place of the old faith in bureaucratic process”. The study also concluded that PPPs present a significant threat to the ‘public service ethos’.<sup>82</sup> Demoralisation and inefficiency were also observed in a study of a UK hospital with a PFI scheme, where non-clinical staff were subject to four different sets of employment conditions - national, local trust, conditions created by a private contractor following competitive tendering, and new conditions of the private PFI contractor. This created problems and animosity, with some staff receiving shift premia for weekend work, and others receiving none. Changes in working practices also had a destabilising effect. For example, the turnover of catering staff rose from 10-15% per annum to over 100% following the PFI, largely due to a change from cooking in kitchens to distribution of pre-cooked meals. (Earnshaw and Ellis 2004).

**- there should be no assumption that a PPP would operate more efficiently than the public sector.**

## 5.6. Transaction costs

PPPs do not create themselves or monitor themselves. There are costs involved in setting them up, negotiating and renegotiating the details, and the monitoring and liaison between the public authority and private company, including legal processes. These ‘transaction costs’ are a key reason why it is often more efficient for public and private organisations to do things themselves, inhouse, rather than contract an outside specialist to do so. PPPs are much more complicated than ordinary contracts, and so the transactions costs are expected to be higher.

An EIB study of roads in central and eastern Europe found that roads built under traditional public sector methods were better on all counts, with transaction costs especially significant for the comparative costs: “traditionally procured highway projects outperformed PPPs on three counts: traditionally procured projects were often implemented faster than PPPs; they were less costly when all costs, notably transaction costs, were accounted for; and they resulted in lower distortions of modal and route choice, largely because toll-free, traditionally procured highways did not, by definition, divert traffic to other (toll-free) roads.”<sup>83</sup>

There is some evidence of the scale of these costs. A study by EIB researchers of transaction costs in 55 PFI projects and 32 EIB projects found that the procurement costs averaged over 10% of the total value of each PPP contract.<sup>84</sup> The UK National Audit Office (NAO) estimated that the procurement costs for the Metronet PFI represented only 2.8% of the project value – but the project itself was so costly, these procurement costs amounted to £455million.<sup>85</sup> On monitoring, evidence from the USA suggests that monitoring the performance of the private sector partner in PPP type of arrangements entails extra costs of between 3 and 25 percent of the contract value. As a consequence, it is recommended in the USA that monitoring costs of 10 percent of the contract value be budgeted in such arrangements.<sup>86</sup>

If the EIB and the USA data are combined, then the total transaction costs for PPP projects could average over 20% of the total project value.

**- the cost of proposed PPPs should always include a sum to cover the costs of contract preparation and tendering and subsequent monitoring costs.**

## 5.7. Uncertainty

A PPP contract, like other contracts, are imperfect (or ‘incomplete’). They cannot cover all the unknown circumstances and possible problems with delivery of service – especially over 25 to 30 years, a common lifetime for a PPP contract. Renegotiations and changes are certain, but their content and consequences are uncertain. The private partner may exploit a monopoly service to the detriment of the people it should be serving. The contractor might fail to perform satisfactorily, or abandon the contract because it is not profitable enough, or go bankrupt. Governments ultimately take responsibility for maintaining the service and repaying bankers, whatever happens to the private partner – these ‘contingent liabilities’ may never happen, but they are expensive when they do. The contract itself is uncertain – it may turn out to have been illegal or corrupt in some way, with possible expensive consequences for the authority – and the public – at a later stage.

These problems do not arise only because of the limits of forecasting, or human error. Companies have vested interest in exaggerating demand in order to get a project approved, or to compete successfully for a contract, especially a long-term one. For example, private companies systematically underestimate the costs of the investments, and exaggerate the expected demand for the service. A global study found that in 90% of road and rail projects, the actual costs end up significantly higher than forecasts in the original bid, and the actual demand is lower than the exaggerated forecast. This happens so consistently that it can only be the result of systematic misrepresentation – i.e. lying.. The authors concluded that: “The problem of misinformation is an issue of power and profit and must be dealt with as such, using the mechanisms of transparency and accountability.”<sup>87</sup>

### 5.7.1. Renegotiations

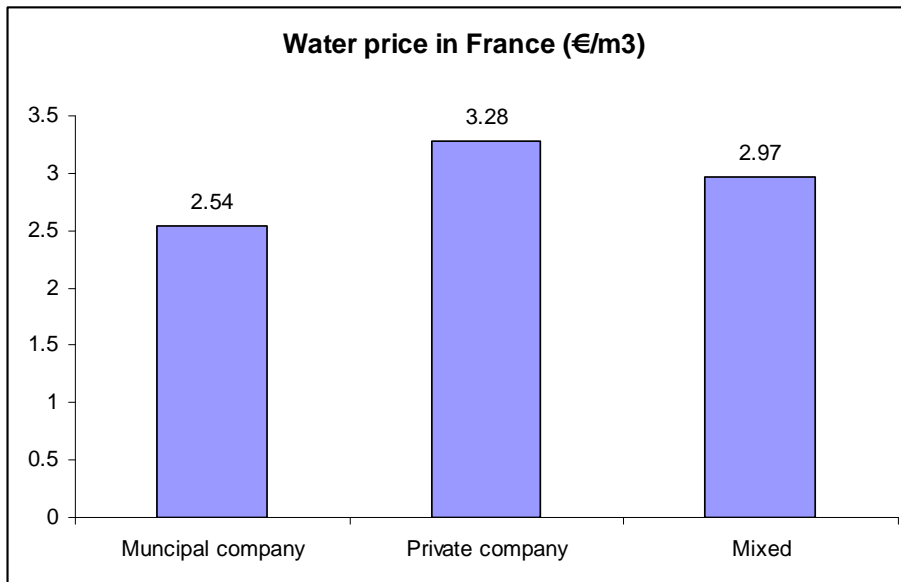
Renegotiations are nearly always to the benefit of the private contractor, at the expense of the public – allowing higher prices or lower investments.<sup>88</sup> In one year in the UK, 2006, changes were made to PFI contracts costing a total of about £180million – and the companies charged an extra £6 million to make these changes.<sup>89</sup> It is hard to ‘learn’ from such problems. The Czech Republic signed a PPP contract to develop a new motorway to Ostrava: in 2002, it was cancelled. An enquiry decided that there needed to be better coordination, a special PPP task force was set up. Then in 2006, two more major PPP contracts were cancelled - for the €22m. Na Homolce Hospital

and an €89m. campus for UJEP university. A report was again produced in 2007, recommending greater standardisation and better 'due diligence'. And so in 2008 the Czech government is still going ahead with plans for PPP projects - including a motorway, a prison, a court building and a hospital that total over €500 million euros.<sup>90</sup>

### 5.7.2. Monopoly

One form of abuse of a PPP is when monopoly concessions are used to overcharge customers. This is a well known problem with monopolies, but there is some recent empirical from the water sector in France which makes it possible to quantify this. A comprehensive study of water PPPs in France, where about three-quarters of the service is delivered by the private sector through PPPs, found that in 2004, after making allowance for all other factors, the price of water under PPPs is 16.6% higher than in places where municipalities provide the service..<sup>91</sup>

Chart C. Price of household water in France, 2004



Source: IFEN 2007

### 5.7.3. PPP contracts annulled

Partly because PPPs are often so large, there are often very few bidders, which weakens the competitiveness which is expected to be the key advantage of inviting tenders from private companies. A number of PPPs have been ruled invalid because they breached basic competition rules, and even involved clear corruption.

#### 5.7.3.1. Denmark: scandal in Farum

The mayor of the municipality of Farum, a small town in Denmark, was committed to radical use of private contractors and PPPs. This included contracting-out of day care to ISS Servisystem, which led to a storm of complaints from parents and the termination of the contracts in 2001. The mayor also set up three construction projects on a PPP basis, including a sports stadium and a marina, negotiated with the same financial group. The deals were opposed on economic grounds by citizens' groups and even by the business press – one business magazine editorial accused the mayor of gambling in the casino with taxpayers money. The mayor was found to have issued the contracts illegally, without proper competition; to have taken out an illegal loan; and to have used council money to subsidise his football team. Local citizens had to pay an extra 3,2% local income tax to rectify the municipal finances. (Carsten Greve and Niels Ejersbo 2002: When Public-Private Partnerships Fail - The extreme case of the NPM-Inspired Local Government of Farum in



Denmark. Paper for Nordisk Kommunalforskningskonference 29 November - 1 December 2002 Odense, Denmark; Borsen October 31, 2001 Outsourcing Strategy Unsuccessful At ISS;)

### **5.7.3.2. France: first PPP cancelled by the court**

The first PPP contract signed under French legislation was annulled by a court ruling in 2008. In 2005 the regional council of Loiret had invited tenders to build a college in Villemandeur, but no bids were received. The council then signed a PPP agreement, without further tendering, arguing that it was a matter of urgency to build the college: the contract was worth €21.7 m. Euros, €13.3m. for the construction and €8.4m. for managing the college for 10 years. The judge ruled that there was no urgency justifying a breach of the law on competitive tendering. (Agence France Presse 30 avril 2008 La justice annule le premier partenariat public-privé pour bâtir un collège)

### **5.7.3.3. Germany: Frankfurt schools problems**

In August 2007 Hochtief took over four additional schools in Frankfurt am Main. This was surprising, given that the city had suffered a considerable debacle with its first PPP school project. The construction of the educational centre using conventional public procurement would have been €4million euros cheaper, according to an audit report. For the next 20 years the contract with Hochtief requires € 12.1 million euros annually which would amount to between 17% and 36% of the total budget for school buildings in Frankfurt, leaving the remaining schools with very small.<sup>92</sup>

### **5.7.3.4. Belgium: an IPPP returns to public ownership**

Aquafin was established in 1990 by the regional government of Flanders to design, finance, build and operate all supramunicipal infrastructure needed to treat domestic wastewater and to optimise all main sewers and wastewater treatment plants. Aquafin is responsible for investments of up to €200m. per year, and the cost of the service is 50% financed through taxation. It is regarded by the EIB as an 'effective operator and contract machine'. Aquafin also sells its expertise to authorities outside Flanders and to industrial clients on the Flemish market. Up to 2005 Aquafin was a PPP, 51% owned by Severn Trent, one of the private English water companies.

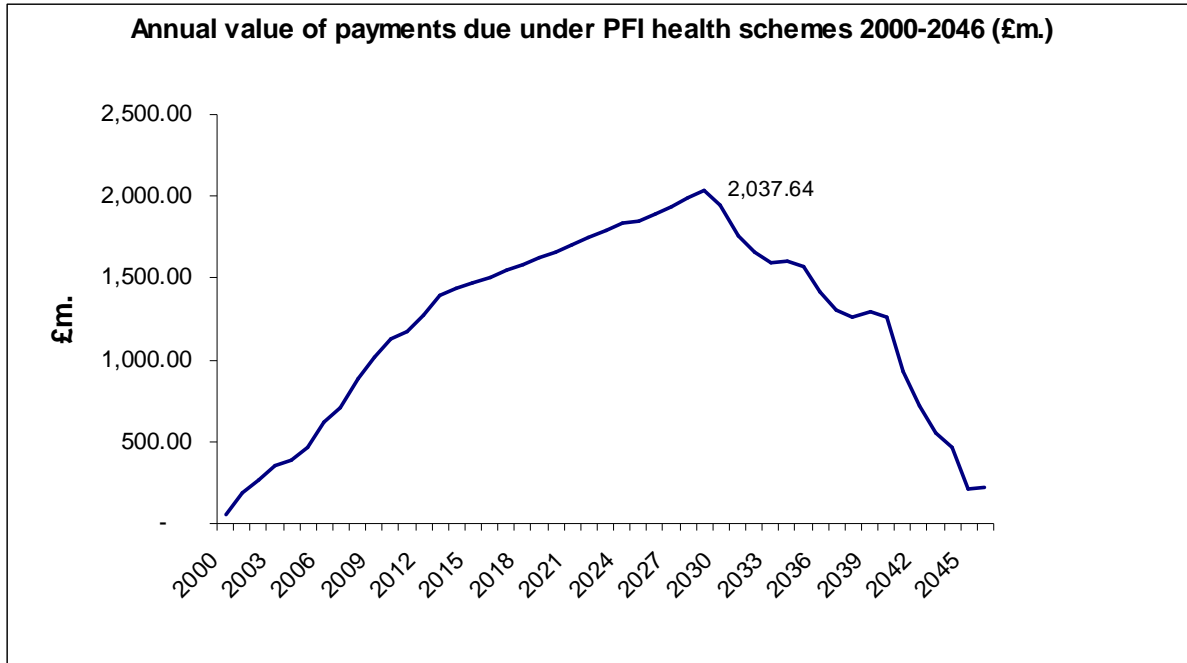
In 2005 the regional authority of Flanders bought out the private sector stake, so Aquafin is now 100% owned by the public sector. This was in response to a formal warning from the European Commission in 2002 that the competition laws had not been complied with correctly when the Flemish government selected private shareholders in 1991, and that the work assigned to Aquafin was in breach of procurement laws.

The return to public ownership has led to a significant reduction in the cost of capital because of the lower interest rates charged to the public sector. Aquafin now has the best possible credit rating because it reflects the credit rating of the regional government: "When the Flemish Region received the very highest score for creditworthiness at the end of 2006, Aquafin's rating increased accordingly to the same AAA level.". This has "significantly reduced the margins on long-term commercial loans and on commercial paper issued. This advantage is passed on to the drinking water consumer". The Flemish government was however considering full privatisation of Aquafin in 2008.<sup>93</sup>

### **5.7.4. Forcing reductions in other services**

The rigidity of the contractual obligations to PPPs can mean that the spending of this money gets priority over other spending, even at the expense of services. The size of PPPs means that the potential displacement effect can be huge. In Portugal, the annual payments to just two major road PPPs cost €800million, are larger than the entire national transport budget of €700million.<sup>94</sup> In the UK. by February 2008, a total of 93 deals had been signed for PFI projects in the national health service, for a total investment of just over of £10 billion. The annual payments by NHS trusts to the PFI contractors continue for the next 38 years, peaking at £2billion per year in 2029, and total £57 billion.

Chart D. Expenditure on PFI schemes in the NHS



Source: calculated from Treasury PFI projects list [http://www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_pfi\\_stats.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_pfi_stats.cfm)

The sheer scale of PFI projects have been a factor in the emergence of deficits of a number of NHS hospital trusts. For the 18 trusts with major PFI schemes in operation in 2005/06, capital costs were 4.3% higher than the amount funded under the tariff. On average NHS trusts with PFI schemes were having to pay 8.3% of their total income in charges and other payments linked to the PFI – more than the 5.8% of income allocated to each trust for capital costs. This funding gap of 2.5% has to be covered by drawing on income intended to pay for services. (Hellowell and Pollock 2007)

The schemes result in large fixed expenditure for many years ahead, which cannot be adjusted in response to changing circumstances, and so transfer unforeseen risks onto that part of expenditure providing services : “many of the building projects impose costs that are not justified in terms of income under payment by results..... Trusts which have much less contracted expenditure – current as well as capital – are going to be much better placed in the near future to cope with the rigours of the reform agenda as it will be easier to adjust to variation in revenue.” (Bosanquet et al. 2006: 10-11)

The problems have been demonstrated at the Queen Elizabeth Hospital trust in Greenwich, which has a major PFI scheme, the costs of which rose to 11.3%, nearly double the government allocation for capital costs. A report by the strategic health authority warned that QEH and other local trusts in a similar situation would: “incur recurrent [income/expenditure] and cash flow deficits even if they operate as efficiently as the average hospital trust in England. A high proportion of their underlying [income/expenditure] and cash flow deficits are attributable to this effect”<sup>95</sup> In 2007 the QEH announced cuts of around 10% in clinical services.

**- allowance should be made for the potential costs of various problems in assessing the comparative value of any PPP proposal**

## 6. The summary case of Metronet: learning from a failure.

In 2007 one of the largest PFI schemes in the UK collapsed. Metronet was one of two PPPs used for maintenance and renewal of the London Underground system. It represented 1/6<sup>th</sup> of the total value of PFI schemes in the UK. These extracts from the parliamentary report on its failure highlight many of the issues covered in this report.<sup>96</sup> The strength of the recommendations should be noted not only in the UK but elsewhere.

- “The return anticipated by Metronet’s shareholders appears to have been out of all proportion to the level of risk associated with the contract. The parent companies were effectively able to limit their liability to the £70 million they each invested in Metronet at the outset. .... In the face of this very limited liability it is difficult to lend any credence to the assertion that the Metronet PPP contracts were effective in transferring risk from the public to the private sector. In fact, the reverse is the case. Metronet’s shareholders, had the company been operated effectively, stood to make quite extravagant returns. Now that it has failed, it is the taxpayer and the Tube passengers who must meet the cost.
- “In terms of borrowing, the Metronet contract did nothing more than secure loans, 95% of which were in any case underwritten by the public purse, at an inflated cost— the worst of both possible worlds..... If finance cannot be secured at reasonable terms without guaranteeing the vast majority of the debt, loans direct to the Government, which would enjoy the highest credit rating and significantly lower costs, would seem to be the more cost-effective option.
- “Metronet’s inability to operate efficiently or economically proves that the private sector can fail to deliver on a spectacular scale, although Tube Lines’ performance provides an example of private sector innovation and efficiency. The evidence is clear: it cannot be taken as given that private sector involvement in public projects will necessarily deliver innovation and efficiency, least of all if the contracts lack appropriate commercial incentives. Future assessments of the comparative value for money of private sector-managed models for infrastructure projects should not assume a substantial efficiency-savings factor;
- “We recommend that the Government, as a matter of urgency, make a full assessment of the additional costs that have been incurred as a result of the failure of Metronet— including the cost of work that has been inefficiently undertaken and the cost of administration.
- “The Government should not enter into any further PPP agreements without a comprehensive and accurate assessment of the level of risk transfer to the private sector and a firm idea of what would constitute an appropriate price for taking on such a level of risk. If it is not possible in reality to transfer a significant proportion of the risk away from the public purse, a simpler— and potentially cheaper—public sector management model should seriously be considered.
- “The Government should bear the Metronet debacle in mind if and when its parent companies -Atkins, Balfour Beatty, Bombardier, EDF Energy, Thames Water - next come to bid for publicly-funded work.
- “The Government should remember the failure of Metronet before it considers entering into any similar arrangement again. It should remember that the private sector will never wittingly expose itself to substantial risk without ensuring that it is proportionally, if not generously rewarded. Ultimately, the taxpayer pays the price.
- “Whether or not the Metronet failure was primarily the fault of the particular companies involved, we are inclined to the view that the model itself was flawed and probably inferior to traditional public-sector management. We can be more confident in this conclusion now that the potential for inefficiency and failure in the private sector has been so clearly demonstrated. In comparison, whatever the potential inefficiencies of the public sector, proper public scrutiny and the opportunity of meaningful control is likely to provide superior value for money.

Crucially, it also offers protection from catastrophic failure. It is worth remembering that when private companies fail to deliver on large public projects they can walk away—the taxpayer is inevitably forced to pick up the pieces.”

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