EPSU PPPs Bulletin

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Public Services International Research Unit (PSIRU), Business School, University of Greenwich, Park Row, London SE10 9LS U.K.

Email: psiru@psiru.org Website: www.psiru.org *Tel*: +44-(0)208-331-9933 *Fax*: +44 (0)208-331-8665

Director: David Hall Researchers: Jane Lethbridge, Emanuele Lobina, Robin de la Motte, Steve Thomas

1. National Developments: Germany

PPPs in Germany have in a number of respects lagged behind other countries, particularly the UK – despite similar pressures on government funds. This has been in large part because the legal framework for PPPs continues to have areas of uncertainty, particularly relating to taxation.[1]

Partly as a result of these issues, the most significant form of PPP to date has been the sale to private investors of minority stakes in Germany's roughly 950 Stadtwerke. (These are municipal works, most commonly covering water and energy sectors, but often also local public transport, telecoms, and others.) In November 2003, more than 290 Stadtwerke had a private investor[2], typically with a minority stake. A considerable proportion of that figure involves the leading German energy companies E.on, RWE and EnBW[3], after a wave of investments following the liberalization of German energy markets in 1998, aimed at securing access to end users and reducing the competition effects of liberalization. Some investment has also come from foreign companies (particularly Suez, Veolia, and some energy companies – notably the publicly-owned Vattenfall), but with relatively little impact, and since 2002 the relative loss of interest from foreign investors has taken the wind out of the sails of Stadtwerke part-privatization. A trickle continues, but is impeded by regulatory problems for the two biggest buyers (E.on and RWE), whose dominance is such that regulators are now preventing some investments[4], and (most significantly in the case of E.on's takeover of Ruhrgas) demanding divestments to balance any acquisitions. A number of these recent divestments have in fact resulted in remunicipalizations, with for example Gelsenwasser taken over by the cities of Bochum and Dortmund, Leipzig reacquiring full control of its Stadtwerke, and Bayerngas taken over by a group of five Bavarian cities. With the effects of energy liberalization now mitigated by a variety of factors (including their Stadtwerke investments), E.on and RWE are now looking mainly to eastern Europe for future acquisitions.

Whilst private participation in Stadtwerke may be slowing, PFI-style PPPs, as well as contracting-out and financial arrangements such as lease-backs and cross-border leasing[5], may continue to rise. This is despite the fact that the British Embassy PPP in Berlin, designed by the British government, remains the reference project for PFI-style PPPs seen in Germany, whilst perhaps the most well-known PPP, for a toll system for lorries, has been disastrously late. The latter also caused a scandal when it emerged that the 17,000-page contract was (by the wishes of the private consortium) 'commercially confidential', and not even available to the relevant parliamentary committee.[6] A recent example of what can go wrong with contracting-out-style PPPs is to be found in the municipality of Oderwitz in Saxony. Here, a project to sell and lease-back the local sports hall resulted in legal action, after it was discovered that the 30-year lease rates were twice as high as the interest rates would have been on a municipal loan. The council was awarded damages – against the regional public auditor that had approved the project.[7]

Despite all this, the Ministry for Public Works is in the process of setting up a PPP infrastructure unit, modelled in part on the UK Treasury's equivalent, aimed at developing PPPs in roads, rail and housing. This follows a report commissioned by the Ministry from a consortium including PwC – probably the leading privatization and PPP consultants – on how to develop and promote PPPs. One of the problems the unit will have to address, according to experts from the private sector, is that productivity improvements are limited as long as contracts include the comprehensive transfer of personnel, with restrictions on firing and changes of conditions.[8] The Bundeswehr (German army) is piloting PPPs in a number of areas, in a manner that would usually be called "contracting out". At state level, North-Rhine-Westfalia is the pioneer in PPPs: the finance minister has a specialised PPP unit (working on projects such as the first German PPP prison), and the Westfalian town of Monheim has recently signed a 25-year deal for the repair and facilities management of local schools – the first in Germany.[9] PPPs are also being promoted by the Deutsche Städte- und Gemeindebund (federation of German towns and municipalities), together with the Zentralverband Deutsches Baugewerbe (construction industry federation).[11] The construction industry sees PPPs as the way ahead, and a potential source of jobs and income.

2. National Developments: PPPs in Italian water sector

The Italian water sector is undergoing considerable changes, most notably since the introduction of the so-called Galli Law in 1994 aimed at reducing the fragmentation of water operators. Prior to the enactment of the Galli Law, water undertakings active in the Italian water sector were mostly publicly-owned with private water companies accounting for only 4.9%[12]. This proportion is changing as more and more local authorities decide to delegate water supply and sanitation services to private undertakings, and private water concessions are being awarded at a pace that currently appears unequalled in Europe.

The Galli Law requires that for each concession area of the 91 identified in Italy, water supply and sanitation services should be provided by one operator only. Thus, the Galli Law does not specifically cover BOTs. However, whether taking place as a result of the implementation of the Galli Law or not, PPPs in the Italian water sector have often been associated with lack of transparency. In Latina, the evaluating commission decided to change the predetermined evaluation criteria after opening the bids[13] and local authorities persisted in awarding the concession to the Veolia/Enel consortium despite the negative advice of the provincial government's legal office[14]. In Milan, a prominent city councillor and a Veolia executive received prison sentences on corruption charges related to the award of a BOT contract for the construction and management of a major wastewater treatment plant. The contract was eventually given to Suez subsidiary Dégremont after it won a court ruling on rather formalistic grounds against Spanish-based Pridesa which had first won the award. Another BOT contract for a second major wastewater treatment plant in Milan was awarded to a Dégremont-led consortium including Veolia subsidiaries OTV and Siba[15].

The two largest water multinationals, Suez and Veolia, dominate the market for private involvement. While Suez has so far concentrated its efforts in Tuscany, Veolia appears to favour the south of the country, where it operates in joint venture with state-owned electricity giant Enel. Veolia and Enel have won the water supply and sanitation concession in Latina, and bulk water supply concession covering the whole of Sicily[16]. Suez Ondeo is well established in Tuscany, where in 1999 it won the first concession to be awarded pursuant to the Galli Law, in Arezzo[17], and was then part of the Acea-led consortia awarded the concessions for Siena[18], Pisa[19] and Florence[20] in 2002-2003. Possible plans to bring all Tuscany operations under one operator would be unlikely not to include Suez. After being hit by the Argentine crisis in 2002 and concerned with risk in developing countries, Suez has identified Italy as "an important growth market in Europe and a Suez priority"[21]. The effects of the group's strategy can be seen in Livorno, also in Tuscany, where half of the 4 bidding consortia include Suez subsidiaries: one consortium is led by Aguas de Barcelona, another (led by Acea) includes 4 minority-owned Suez subsidiaries.[22]

3. National Developments: PPPs in Portuguese hospital sector

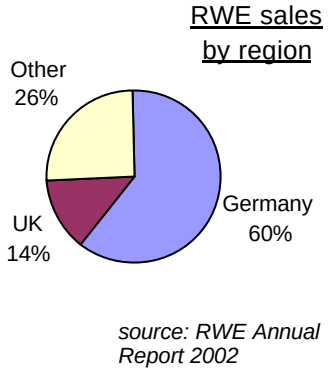
The Portuguese government in 2002 revised the legal framework on PPPs, and announced plans to allow private providers and private managers of public hospitals to supply health services to the National Health Service (SNS). It also announced the construction of 10 new acute PFI hospitals (the first tender was launched in December 2003[23]), each with a capacity of between 300 and 700 beds. The contracts have a combined build value of around €1bn, and because of their scale (and the fact that there are only three or four major Portuguese construction companies) are expected to provide room for UK companies to get involved. As one consultant remarked, "The Portuguese are very anglophile in their attitudes, and they see the UK as the home of this type of PPP."[24] However, the Portuguese contracts go beyond the UK model, as they will include clinical services in addition to the typical building and facilities management activities transferred in UK PFI deals. As a result, the private sector partner will be responsible for 100% of the hospital's budget, as opposed to around 20% in the UK.

This new wave of PPPs follows on from the first Portuguese hospital PPP, Amadora-Sintra, as well as PPPs in power plant, bridge and road construction.[25] Whilst Amadora-Sintra, which began operations in 1996, was not a strict PPP (the government built the hospital with public money, and then sublet it to a leading Portuguese company, Jose Manuel de Mello Saude), it has been seen as a PPP pioneer, despite severe criticism from some quarters for various irregularities. This has included allegations of over-charging and use of fraudulent expense claims (a state auditor in mid-2003 found over-charging of €75m, although an

arbitration court controversially overturned this), allegations of misuse of hospital property for private clinical services, and the fact that the contract with the hospital was signed in 1995 by the outgoing health minister after the electoral defeat of the government, and subsequently went to work for the de Mello group.[26] Additionally, in 2001 a National Institute of Administration report concluded that expenditure (paid for by the health service, SNS) had between 1996 and 2000 grown 19.7% in the Amadora-Sintra hospital, as against 7.8% in a comparable local (public) hospital with a similar rise in output.[27]

4. Company news: RWE

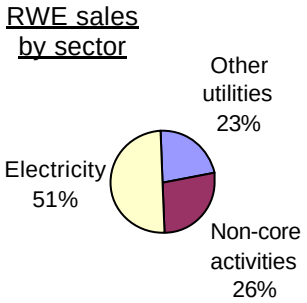
RWE is a large German conglomerate. The company's core strength was and is electricity in Germany, but with 132,000 employees and annual net sales exceeding €46 billion[28], RWE ranks among Europe's largest industrial corporations. It is Europe's third-largest electricity supplier, water supplier, and waste management operator, and is a leading gas supplier.



source: RWE Annual Report 2002

In 2003, under the new Chief Executive Harry Roels, RWE restructured itself, to reduce 13 divisions to 7, with the aim of saving €300m a year (among other things through the loss of 1000 jobs, albeit without compulsory redundancy). The aim was also to strengthen the multi-utility strategy (i.e. supplying customers with two or more of electricity, gas, and water), through a regional structure within the new divisions that is intended to facilitate cooperation with municipal works and regional suppliers, under the slogan "one face to the customer".[29] The restructuring process included some expensive growing pains, as municipalities proved reluctant to give up their previous 20.03% municipal stake in RWE Gas, finally agreeing to give up the stake within a few years, at a cost to RWE of €1.14bn.[30] The deal allows RWE Gas to be subsumed into the new RWE Energy, which will manage both electricity and gas distribution.

As part of it multi-utility strategy, RWE strengthened what had been the weakest of its four core business pillars (electricity, gas, water, waste) by taking over Thames Water, the largest UK water company, and the most active internationally, in September 2000, and the largest private water company in the US, American Water, in January 2003. Following the takeover of American Water Works (AWW), which was completed in January 2003, RWE is now the world's third biggest (private) water supplier, with "some 70 million customers in 46 countries worldwide".[31]



source: RWE Annual Report 2002

Financial markets have however been somewhat sceptical, in January 2003 valuing RWE at a 40% discount to the sum of its parts, pointing to a string of over-priced acquisitions, which took net debt to €26bn.[32] Indeed, there is scepticism about the very strategy of becoming a multi-utility: "With the notable exception of French company Suez, RWE is bucking the trend followed by other European utilities in including water in its portfolio. The multi-utility craze has largely been abandoned in the rest of Europe, with companies concentrating on electricity and gas and even RWE's arch rival E.ON driving to pare down its businesses to core operations."[33]

Along with the multi-utility strategy, RWE has also (along with other multinationals) had the strategy of investing heavily in eastern Europe, and debt permitting, expects more acquisitions there. It has acquired for example, Warsaw's electricity distributor, Stoen, as well as virtually the entire Czech gas industry. The final pillar of RWE's recent strategy has been a sensitivity to political risk. Recently, RWE-Thames in particular has evolved a political risk strategy in response to a number of high-profile problems in overseas privatizations, both in its own operations and in those of other multinationals. As a result, at recent international water meetings, such as the Third World Water Forum in 2003 in Kyoto, Thames has declared its intention to avoid controversial (and therefore riskier) privatizations, particularly in developing countries.[34] In this it is not alone – all the big water multinationals (Suez, Vivendi, SAUR) have voiced

increased scepticism about investment in developing countries, and, to varying degrees, begun disinvestment processes, sought increased guarantees, and refocussed strategy towards the securer markets of Europe and North America. However, Thames is alone amongst the water multinationals in recent statements that the water sector should not be covered in the GATS agreement. Thames is also developing a new model for private investment in water in developing countries, involving cooperation with NGOs to develop specific projects. This would reduce the risks to the company (by reducing opposition, or avoiding projects with strong opposition),allowing it to accept a lower rate of return, and help prevent embarassing withdrawals.

5. Publications: recent academic publications

5.1. Grimshaw et al (2002) - "Going Privately: Partnership and Outsourcing in UK Public Services"

The involvement of private sector organizations in the delivery of public services is probably more highly developed in the UK than anywhere else in Europe, both in policy and in practice. In the UK, privatization, contracting-out and PPPs have "challenged and transformed traditional notions of the government's role as employer and service provider". Grimshaw et al (2002)[35] carried out two case studies (on an NHS PFI hospital, and an IT contract), and a survey of academic studies, which supported the conclusion that contracting-out has been leading to a two-tier workforce, with pay-and-conditions suffering in competitive tendering, regardless of whether tenders are won by the private or the public sector.

In both case studies, the public sector did not invest sufficient resources in accounting and supervisory capacities to effectively oversee the contract, and monitoring the performance of the contract was very difficult, since the inhouse expertise is by definition lost. The NHS case also showed how the private sector, with its greater experience and resources devoted to contract negotiation, had a relatively free hand in setting and interpreting the terms of the contract.

The authors also cite one study which found that even when cost savings are achieved, savings in one area can translate into costs elsewhere: Escott and Whitfield (1995)[36] concluded that contracting-out (under CCT) was costing the national government £126m a year, because savings in job cuts were offset by lost taxes and increased unemployment benefits. Grimshaw et al note that the Labour government (from 1997) has not heeded these earlier lessons, with the focus still on the immediate, local situation without regard to the big picture.

The paper notes a number of other issues. A noted problem in the NHS case study was the clash of management styles in relation to the workforce and trade unions in particular, with the private sector, used to a confrontational style, only reluctantly adapting to the traditional consensual style of the hospital. They also point out the lack of research on the potential erosion of the public sector ethos, and an attendant decline in the quality, distinctiveness, and perhaps productivity of services. Additionally, a key part of PFI is benchmarking – comparing the costs of various inputs and outputs in order to judge value-for-money. Even where this is not impeded by commercial confidentiality and other difficulties, it encourages a focus on benchmarkable outputs – excluding less tangible, though equally important features such as organizational learning or degree of political responsibility.

5.2. Froud (2003) - "The Private Finance Initiative: Risk, Uncertainty and the State"

Many of the practical problems associated with PFI are well known – including the problems of writing complex, long-term contracts, the difficulty of effective risk transfer (including the fact that risk is in any case often best borne by the state), the greater financing expense, and the danger that the need for private sector involvement distorts the nature of the projects chosen under PFI. In addition to these practical problems, which PFI consultants would argue are being addressed through experience, Froud (2003)[37] argues that PFI suffers from a much more fundamental problem, namely that it rests on a confusion between risk and uncertainty. The distinction between the two can be put as the difference between the risks we know of

and can calculate, and the risks we don't even know about. In the cost-benefit calculations at the heart of PFI, decisions are typically based on risk analysis, whilst uncertainty is largely ignored.

The result of this is that the state willingly enters into long-term (25-to-30-year) PFI service contracts that strongly limit its future ability to respond to the changes an uncertain future may bring. As Froud puts it, "PFI is significant in leading to a voluntary surrender of the powers of the state. … In effect, the denial of uncertainty in the technicist calculations of PFI means that it is borne by a state that has reduced its own powers to act." Crucially, although the state may be able to transfer a particular project's risk to private partners (though this is difficult and expensive), it cannot transfer ultimate responsibility for the public interest which the project is intended to serve. Uncertainty – tomorrow's potential problems that we haven't thought about today – drives a wedge between these two things, and the longer the project runs, the bigger the wedge. A private partner may bear the risk of a hospital going bankupt, but when that day comes, it is the state that must pick up the pieces. Examples abound, from the repeated bail-outs of the privatized UK rail industry to the bailout of the PFI-built Royal Armouries Museum.

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[2] Dr. Marc Weinstock and Niclas Karoff, FINANCE - Der Markt fuer Unternehmen und Finanzen, 29. November 2003 "Energiemarkt: Die Stadtwerke im Fokus; Privatisierung stockt; Warum es kaum noch Kaeufer fuer Stadtwerke gibt"
[3] E.on, RWE and EnBW, together with the Swedish-owned Vattenfall Europe, have 80% of the German energy market.
[4] For example, E.on has recently been prevented from buying a 30% stake in Stadtwerke Eschwege, and a 49.6% stake in Stadtwerke Luebeck. (Neue Zürcher Zeitung, 25. November 2003, "Rotes Licht für E.On"), while four RWE investments were only permitted on the condition that it sold its stakes in the Stadtwerke of Leipzig and Duesseldorf. (Utility Week, 14 November 2003, "RWE gets OK to bag four town utilities").
[5] In July 2003 it was estimated that there were 150 German cross-border-leasing projects, with a total value of €36bn. For example, Cologne has long-term-leased its sewer system to a US financial investor, whose tax advantages allow it to lease the system back to Cologne at a slightly lower price. (Axel Hartmann, Focus-Money, 24 April 2003, "Infrastruktur-Finanzierung; Private Vorteile"). Financial penalties may apply for the city if the asset is not fully utilized, and there are other risks and complications (see previous PPPs Bulletin).
[6] The BDI (an organization representing industry) nonetheless opposes an expansion of parliamentary oversight of federal PPP projects – on the grounds that PPP projects require "room for entrepreneurial freedom of action" which is "incompatible with parliamentary oversight".
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[13] "Two steps forward and one step back in Italy", *Global Water Report*, Issue 125, 6th July 2001, pp. 1-2.
[14] "Italy/Privatisation – Vivendi takes Latina", *Global Water Report*, Issue 127, 3rd August 2001, p. 5.
[15] "Bribery and delays keep Milan infrastructure waiting", *Global Water Report*, Issue 131, 15th October 2001, pp. 1-3.
[16] "Italy/Companies – Enel and Veolia win Sicilian concession", *Global Water Report*, Issue 177, 22nd August 2003, pp. 8-9.
[17] "Setback in Arezzo", *Global Water Report* 125, 6 July 2001, p. 2.
[18] "Italy/Privatisation: Legal hurdles and regional wins", *Global Water Report*, Issue 163, 28th January 2003, pp. 7-8.
[19] "Italy/Companies: Further success for Acea", *Global Water Report*, Issue 164, 7th February 2003, pp. 8-9.
[20] "Acea and Ondeo in third joint win in Florence", *Global Water Report* 175, 18 July 2003, p. 5.
[21] "With two new successes, SUEZ and Acea strengthen their partnership in Italy", Suez Press Releases, 31st January 2003.

[22] "Italy/Companies – Livorno tender progress", *Global Water Report*, Issue 185, 19th December 2003, pp. 8-9.
[23] Building Design, 5 December 2003, "Brits flood in for Portuguese PFI"
[24] Patrick Waterfield, head of PFI at consultants Cyril Sweett, which has been appointed as advisers to Jose de Mello, quoted in Public Private Finance, July 2003, "Portuguese hospitals 'could hit UK market'"
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