CEE bankwatch network

Policy Comments

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CEE Bankwatch Network's mission is to prevent environmentally and socially harmful impacts of international development finance, and to promote alternative solutions and public participation.

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CEE Bankwatch Network comments on EC Communication on public private partnerships, 19.11.2009

As part of our work on preventing the harmful impacts of international development finance in central and eastern Europe (CEE), Bankwatch is concerned that public-private partnerships in infrastructure are being heavily promoted in CEE even though the evidence from the use of such models so far, both in the region is mixed or sometimes absent.

We would therefore like to take this opportunity to comment on the EC's Communication on *Mobilising private and public investments for recovery and long-term structural change: Developing public private partnerships* from a CEE perspective and ask the EC to take this into account when carrying out its follow-up work.

Please note that **our comments relate only to PPPs for the construction and operation of public infrastructure**, and our comments are not necessarily applicable to research and technology PPPs.

The EC Communication assumes that PPPs are inherently positive and should be promoted, whereas our experience with PPPs in CEE suggests that **there are strong inherent limitations in the usefulness of such models for public infrastructure**. Some of the problems can be solved by a strong, experienced and transparent public authority, however others, such as the lack of private sector risk during the operation stage involved in most motorway PPPs, or the limitations that PPP payments impose on non-PPP budget lines in the same sector, are difficult if not impossible to overcome.

It is often assumed that this will be resolved by carrying out more PPP projects and gaining more experience. However this brings the threat of committing too many public resources for the coming decades, particularly in smaller economies. In addition, some of the issues, such as the difficulties in imposing penalties for poor performance when it is in no-one's interest that the project fails, severely impact on the public authority's ability to transfer risk even when relatively experienced in carrying out PPPs.

1 For an overview of our concerns regarding PPPs in CEE, see our November 2008 publication *Never mind the balance sheet - the dangers posed by public-private partnerships in central and eastern Europe*.

Specific comments on the Communication

"PPPs have a track record of on-time, on-budget delivery." (p.3)

This claim is not backed by reliable evidence. The National Audit Office (NAO) report quoted in the footnotes relates to the UK only, and has been criticised for being based mostly on discussions with PPP project managers, who would naturally be likely to downplay problems with projects. The NAO also warns in the foreword that "the figures should be treated with caution for reasons of data availability and comparability which are explained in the paper."[2]

Although it does not say so directly, the implication of the EC statement is that PPPs are more likely to be on time and on-budget than traditionally procured projects, however the NAO report points out that *"the factors perceived as critical to the successful PFI [PPP] contracts, such as thorough due diligence, clear output specifications, and skilled contract management, may be transferable to non-PFI contracts. Good practice can flow in both directions between PFI and non-PFI' ".*

A similar point is made in the EIB evaluation mentioned in the EC Communication: *"The evaluation found that the underlying physical projects evaluated in-depth were largely completed on-time, on-budget and to specification. This reflected the use of fixed-price, fixed-term turnkey construction sub-contracts. These are common in PPP structures, but could also have been applied to public procurement."*[3]

Perhaps most importantly, the evidence quoted by the EC does not take account of the fact that in PPP projects, price increases and deadline extensions may be negotiated before the contract is signed, especially during the preferred bidder stage: it examines only the relation between the contract and the actual implementation. A 2007 study found that indeed the capital values of 43 UK hospital PPPs increased by an average of 74 percent between the Outline Business Case stage and the contract signing.[4] If this is typical for other PPPs, it is not surprising that fewer increases take place after the contract stage.

"Better value for money from infrastructure, by exploiting the efficiency and innovative potential of a competitive private sector to either costs, or achieve a better quality ratio." (p.4)

This assertion is highly questionable – public sector comparators are often not carried out at all for PPPs in central and eastern Europe, so it is often unclear whether PPPs offer better value for money than publicly procured projects. Even when such calculations are carried out they can be manipulated, for example through the choice of discount rate, to achieve the desired outcome.

Efficiency gains are highly dependent on the sector. It is unclear where are the opportunities for innovation on some relatively simple PPP operations eg. the maintenance part of motorway PPPs. In addition the study on water and electricity quoted in the EC Communication[5] finds that greater efficiency does not consistently translate into either lower costs, or greater investment, meaning that either the starting point was so low that the increased efficiency still only contributes to a minimally functioning service, or that it translates simply into profits for the company.

2 UK National Audit Office, Private Finance Practice: *Performance of PFI Construction*, October 2009

3 Campbell Thomson, Judith Goodwin: *Evaluation of PPP projects financed by the EIB*, EIB, March 2005

4 Mark Hellowell and Allyson M Pollock: *Private finance, public deficits: A report on the cost of PFI and its impact on health services in England*, Centre for International Public Health Policy, University of Edinburgh, 12 September 2007

5 http://www.ppiaf.org/content/view/480/485

"Spread the cost of financing the infrastructure over the lifetime of the asset." (p.4)

This no doubt looks appealing to some of today's decision-makers, trying to keep public debt levels down while still investing in infrastructure. However it limits the choices of future decision-makers by tying them into long contracts for infrastructure which they may never have chosen to build.

"Improve risk sharing between public and private parties." (p.4)

This has proven difficult to implement in reality, firstly because the private sector charges high sums for taking on risk, and secondly because much of the risk in PPPs is ultimately untransferrable. As it is in neither party's interest that a project fails, either the public sector ends up assuming risks (eg. demand risk) or the private partner is paid highly for very low-risk work.

For example with motorway PPPs, the failure of pure toll motorways in Hungary due to lower than predicted traffic levels has led to subsequent PPPs in CEE countries involving either a guarantee from the public sector for income from tolls, or the PPP has been developed on an availability fee basis. Yet the payment of an availability fee means that once the road is built, there is almost no risk for the private partner, which merely has to perform some maintenance and clear some snow occasionally.

"In the past, there was a concern that Member State governments could use PPPs as a way to conceal their expenditure and new liabilities on public balance sheets, loading up costs for the future, in contradiction with the Stability and Growth Pact rules." (p.5)

It is not clear why this is said to be in the past. The Eurostat rules still mean that some projects where little real risk is transferred do not have to appear on the balance sheet – eg. the operation stage of motorway PPPs.

"The LGTT is a guarantee facility that helps by partially covering these risks by making up shortfalls in revenue that result from lower than expected traffic growth in the early operational periods of projects. In this way, it improves the financial viability of a project and its overall credit quality." (p.8)

This again raises the question of risk transfer and the use of private financing. If a project needs to be guaranteed with public money then there is little or no risk transfer during the operational stage. Why is a similar facility not offered for publicly financed projects?

It is particularly worrying that income guarantees are extended for motorway projects. EU transport and sustainable development policy promotes modal shift from road and air transport to rail and urban public transport, walking and cycling. If a motorway project is not obviously financially viable, its construction should be reconsidered.

"Construction cost based grant in the framework of availability payment schemes

"This special grant scheme encourages the project promoter to enter into a PPP agreement with a private partner rather than use public grants to finance the construction. The TEN-T grant, equivalent to up to 30 % of the total construction cost, is used by the promoter to support payment obligations only once the project is completed. This improves affordability for the public sector, while maintaining risk transfer to the private partner." (p.8)

This does contribute to transferring construction risk to the private partner, but it does not ensure that demand risk is transferred. It also does not ensure that the PPP offers better value for money than public procurement options.

"4.2. Challenges inherent to complex procurement models such as PPPs

"They require a set of specific skills within the public sector, involving the preparation, conclusion and management of contracts. The range of complex financial arrangements required for PPPs and the relative lack of expertise in such matters may limit the capacity of the public sector to deliver good PPPs. Training and assistance are therefore necessary to accumulate the necessary knowledge for the sound preparation of PPP projects." (p.11)

Indeed, any partnership is only as good as the weakest partner. However in central and eastern Europe it is not only training in PPPs which is needed, and it would probably have a greater net effect if more effort was put into training decision-makers in developing coherent sectoral strategies and plans and developing projects in an analytical and participatory manner. Corruption and the prevalence of special interests continues to be a problem that is only encouraged by complex arrangements such as PPPs, and therefore much greater transparency of PPPs is needed before they can be considered to make a positive contribution in the region.

"5. THE WAY FORWARD: WHAT NEEDS TO BE DONE?" (p.12)

Before improving access to finance and expanding the EIB's role in PPPs the EU needs to first undertake a more thorough analysis of whether and if so under what circumstances PPPs are truly effective and provide good value for money.

On p.11 a few issues are mentioned: *"Successful PPPs need to be designed to allow private partners the potential to generate a return proportionate to the risks they undertake. Since risks are shared with public partners, returns should also be shared. Bidding processes must be competitive and require an appropriate regulatory and financial framework at national level. Public entities should have flexibility in the types of agreements they can conclude, and retain the possibility to award contracts according to value for money, provided for by the best mix of private and public risk allocation."* The list could be expanded to include a need for thorough affordability and value for money analyses, disclosure of project documents and cash costs of payments, limitations on changes to the contract during the preferred bidder stage, and thorough enforcement of penalties foreseen in contracts. Few if any of these conditions are regularly met in PPPs in central and eastern Europe.

In terms of financing TEN-T, maximum attention should be paid to smart investments such as transport management systems before considering large new infrastructure projects, particularly motorways. Most CEE rail networks have good coverage but are suffering from decades of underinvestment, and it makes sense to upgrade these before embarking on new motorway construction projects. Yet in reality developments usually happen the other way round, with motorway development taking precedence. This is not only expensive but endangers the EU's ability to reach its 2020 climate targets.

"3. Ensure **proper debt and deficit treatment of PPPs** through:

"Examining the implication on the 'balance sheet' treatment of PPP assets of revised financing arrangements and issue clarifications on the existing accounting treatment in national accounts of PPP contracts." (p.13)

Availability risk should be considered a defining factor only if the risk is significant. Maintenance of motorways for example can hardly be considered a major risk.

Individual and cumulative PPP commitments for the coming decades should be available to the public even if the PPP is not on balance sheet, and it should be clear which budget these are to be met from.

"Working with Member States to identify provisions in national legislation that prevent or hinder setting up PPPs, as part of the implementation of the European Economic Recovery Plan. Where the EU funding is involved, it should be ensured that there is no discrimination in the allocation of funds to investments projects depending on the management of the project, be it private or public." (p.14)

This statement slightly contradicts the one page 12 that *"The ultimate decision to use PPPs lies with the Member States' public authority and it is for the Member States to review the national framework as necessary to enable it."*

EU law on public contracts and concessions is neutral as regards whether Member States choose to provide a public service themselves or to entrust it to a third party[6], but the EC's Communication heavily promotes PPPs to an unjustifiable extent in our view. We hope that our concerns raised above will be taken into account as the EC undertakes its follow up work on the Communication and that a wide range of stakeholders will be consulted.

6 European Commission Green Paper on public-private partnerships and Community law on public contracts and concessions, COM/2004/0327 final, 2004.