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Public-Private Partnerships:

In Pursuit of Risk Sharing and Value for Money

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## Executive Summary

Although private firms have been involved in public service delivery for a long time, the introduction of public-private partnerships (PPPs) in the early 1990s established a mode of public service delivery that redefined the roles of the public and private sectors. Throughout the 1990s and early 2000s, increasingly more countries – both within and outside the OECD area – started using this mode of delivery. The early trend setters include Australia and the United Kingdom, but by 2004 the list also included countries such as France, Germany, Ireland, Italy, Japan, Korea, Portugal, Spain, Turkey, Argentina, Brazil, South Africa and several others. Governments introduced PPPs for various reasons: to improve the value for money in public service delivery projects, or because PPPs had the potential of bringing private finance to public service delivery. Because many governments experienced the pressure of fiscal deficits and increasing public debt burdens by the mid 1990s, the perceived promise of private finance was alluring, especially for large infrastructure projects. During the last decade in particular, governments increasingly recognised that PPPs are an instrument to improve value for money although they do not necessarily constitute an additional source of previously untapped finance. Having said this, there is still a lack of clarity about the definition of public-private partnerships as well as the relationships between affordability, budgetary limits and access to private finance.<sup>1</sup>

The introduction of PPPs also raised a series of political, economic and technical questions. The first issue is whether there should be public or private provision of services that are traditionally provided by the public sector. The answers to this question involve economic and political choices that depend on the relative efficiency of public services in a given country, on the potential availability of capital, and on the social consensus about

acceptable ways of delivering certain services. The public and social acceptability of such partnerships is often a key factor. The economic questions concern issues such as contract management and risk sharing, which are done to maximise value for money. A number of tests are involved, relating to affordability, risk sharing and competition as well as providing a benchmark with a public sector comparator. In these decision processes and tests, budget decisions are a key factor, as some public authorities may see PPPs as a way to shift part of their debt off their books, particularly when they are faced with fixed ratios of acceptable public sector indebtedness.

At a more general level, engaging in a PPP process will require governments to define clear legal and policy frameworks and to ensure that the appropriate capacity exists within the government to initiate and manage PPPs. Ensuring an enabling environment for PPPs also has implications from the perspective of public governance, as the public sector needs to establish itself as a credible partner with appropriate regulatory and oversight mechanisms. This condition is particularly important, as public-private partnerships are often managed by decentralised authorities or local governments who must deal with major private sector actors.

Through a joint regulatory and budgetary perspective, this book undertakes a systematic analytical discussion of the issues mentioned above. The aim is to provide governments with a toolkit of issues to be explored and resolved from a public governance perspective before engaging in a PPP project. The book also defines possible good practices for the public sector to maximise the potential for PPP projects and to ensure that they are used appropriately to maximum general interest.

The systematic analytical discussion begins with a clearer definition of PPPs. A public-private partnership is defined as an agreement between the government and one or more private partners (which may include the operators and the financiers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners. In making this clearer definition of public-private partnerships, the book also briefly considers the distinction between PPPs and concessions: it is recognised that there are significant similarities between PPPs and concessions (and, indeed, such similarities also mean that some of the lessons learned with regard to concessions can be applied to PPPs, and *vice versa*). Nevertheless, the book distinguishes between public-private partnerships and concessions on the basis of the amount of risk carried by the private provider, as well as the main source of income of the private provider (*i.e.* user charges and fees paid by the government).

Given the key role that affordability and value for money play in the success of public-private partnerships, the book discusses related issues in some detail. With regard to value for money, the discussion focuses on risk transfer and competition. The book argues that sufficient transfer of risk to the private partner is necessary to ensure efficiency and value for money. For the transfer of risk to be the most effective, risk must also be transferred to the party best able to carry it. By defining risk as the probability that the actual outcome (*i.e.* sales, costs and profits) will deviate from the expected outcome, and by distinguishing between endogenous and exogenous risks,<sup>2</sup> the book argues that efficiency depends on a sufficient transfer of endogenous risk to the private partner. The book also refines the principle that risk should be transferred to the party best able to carry it, by clarifying that “best able to carry it” means the party who can carry the risk at least cost, be it the government or the private partner.

The book also emphasises the importance of sufficient competition to ensure the effective transfer of risk. More specifically, a distinction is made between competition in the bidding process and competition in the provision of the service once the PPP contract has been concluded. Competition in the bidding process improves the bargaining position of the government and prevents opportunistic (monopolistic) behaviour on the part of the private bidders. Thus, competition in the bidding process helps a government to attain better value for money. Once the contract is concluded, competition ensures that the private partner delivers the agreed value for money because competition prevents moral hazard and limits the capacity of the private partner to force the government to renegotiate the terms of the contract. In the absence of competition, the government may, in effect, continue to carry the risk, even when risk has been transferred according to the PPP contract.

Following the discussion on the roles of risk transfer and competition to ensure value for money, the book examines the performance measurement of PPPs, with examples from several countries that use public-private partnerships. In addition, the report discusses the need for an institutional capacity to create, manage and evaluate PPPs. Dedicated units may help to ensure that public-private partnerships are handled properly and that there is appropriate knowledge available, and also regulate the creation of PPPs to ensure that they fulfil their requirements. These units need to be staffed with experts who are able to negotiate with peer public agencies and regional agencies as well as the private sector. The book discusses the type of expertise required for PPPs, as well as the required governance framework.

The book also discusses the policy framework for public-private partnerships. Political commitment at a high level is crucial for assuring private actors that commitment remains over the long run and that political risks will be minimised. The political commitment may also help convince

the public about the value of PPPs as a mode of service delivery. The book also highlights the importance of adequate regulations concerning corruption and ethical conduct as part of the PPP policy framework.

Finally, the book discusses regulatory questions such as transparency, the need for a legal framework, and compliance and enforcement issues. Access to information at all stages of PPP development will help increase transparency and efficiency in the process and may reduce opportunities for corruption. The regulatory framework needs to ensure that the PPP contract will align the objectives of the government and those of the private sector. Compliance and enforcement require that public institutions be able to monitor the conditions under which the service is delivered.

The book identifies possible good practices for the public sector to maximise the potential for PPP projects and to ensure that they are used appropriately to maximum general interest. These practices involve: affordability; value for money; fiscal rules and expenditure limits; risk sharing; the need for competition and transparency; regulatory issues; adequate institutional capacity; the public sector comparator; and the importance of political support.

## Notes

1. Private sector participation in infrastructure was discussed for several core sectors – including electricity, water and transport – as part of the OECD International Futures Programme (OECD, 2006c and 2007a). In 2007, the OECD published the *OECD Principles for Private Sector Participation in Infrastructure* (OECD, 2007b).
2. Unlike exogenous risk, endogenous risk represents the case where the private partner can do something to ensure that the actual outcome approximates the expected outcome.