The Economics of Public-Private Partnerships

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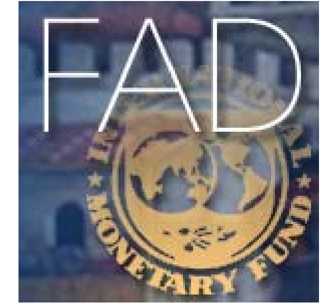
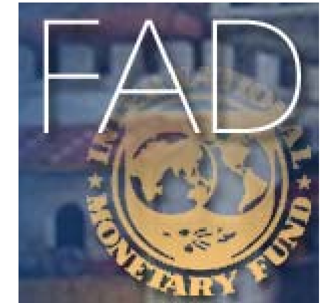
Structure of the Presentation



- Preliminary Considerations
- Key Features of Successful PPPs
- Fiscal Risks and Fiscal Accounting

Preliminary Considerations

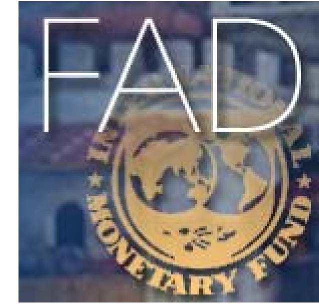


- PPPs: Arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the Government. PPP contracts stress long-term service delivery rather than asset creation; services can be provided to the government or directly to final consumers.

- Country experiences suggest that PPPs are best suited for economic infrastructure, such as highways and ports.

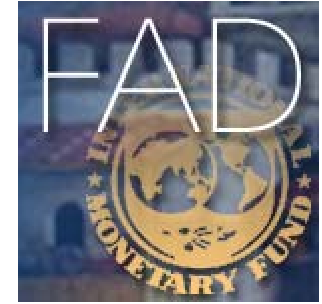
- However, in some countries (e.g., U.K.) they have also been used successfully for certain social infrastructures, such as hospitals, schools and prisons.

Preliminary Considerations



- PPPs offer significant potential benefits:
  - Efficiency from private sector involvement
  - Internalize the benefits from building high quality physical assets
  - Likelihood of better maintenance of assets
  - Contrary to widespread beliefs, financing considerations should not be key.
- For PPP benefits to be realized, incentives have to be right.
- Experience shows that institutional and legal factors play an important role in ensuring the success of PPPs.

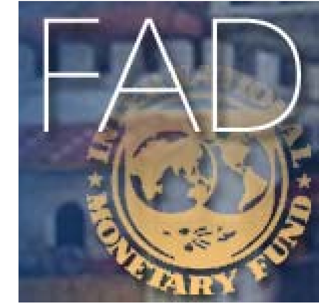
Key Features of Successful PPPs



1. An appropriate legal and institutional environment:

- A clear and sound legal framework establishing the basic requirements for PPPs and mechanisms for dispute resolution and cancellation of contracts.
- Strong political commitment, good governance, and a well-functioning judicial system (needed to assure investors that contracts will be honored).
- Appropriate administrative structures within the government, including skilled staff dedicated to overseeing the design and implementation of PPPs.

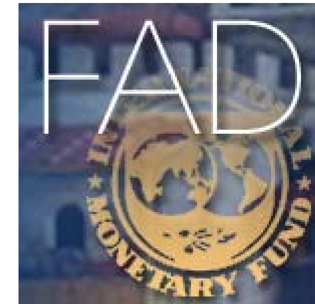
Key Features of Successful PPPs



2. Well-Informed Decision Making:

- Systematic use of sound cost-benefit analysis of proposed projects, to ensure adequate rates of economic and social return.
- Systematic use of public sector comparators, to inform the choice between PPPs and direct public procurement.

Key Features of Successful PPPs



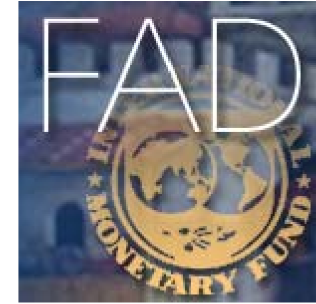
3. Clear, unambiguous contracts, to help reduce the risk of lengthy and costly renegotiations. Contracts should define in detail:

- Features and quality of PPP outputs
- Allocation of risks
- Rules for dealing with unforeseen events
- Step-in rights in the event of default of private partner
- Conflict resolution mechanisms.

4. Open, competitive, and transparent procedures for bidding and awarding of contracts.

5. A predictable and non-discriminatory regulatory environment.

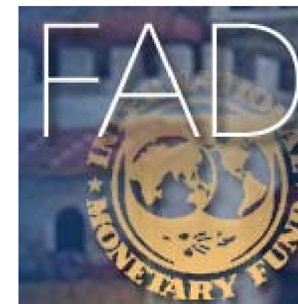
Key Features of Successful PPPs



6. Appropriate sharing of risks between the public and the private partners.

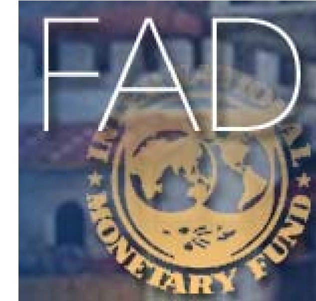
- Basic rule: governments should not go for maximum risk transfer to the private partners; instead, they should shift the risks that the private sector is better equipped to bear. Typically:
  - Construction risk
  - Availability (performance) risk
  - Normal commercial risks
- Governments should bear *political* risk and risk related to *policy and regulatory uncertainty*.
- Circumstances may advise sharing *demand risk*; in this case, the government's share must be transparently reflected in the fiscal accounts.
- Inappropriate sharing of risks reduces value for money for the government.

Fiscal Risks and Fiscal Accounting



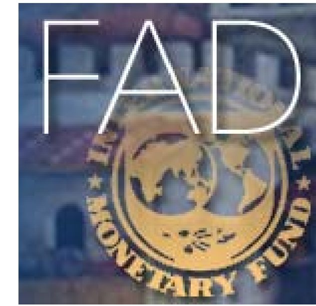
- Risk-sharing in PPPs will be affected by the institutional setting, sometimes with adverse results.
- In particular, public accounting rules for PPPs may create incentives that skew the allocation of risks, resulting in an inefficient design of the partnership.
- Current public accounting rules tend to set up tests for classifying a PPP fully in the public or the private sector. This may create incentives for governments to design PPPs (including risk sharing) so as to move them off their books, even at the cost of reducing value for money.
- International accounting standards should be developed that reflect transparently in the fiscal accounts the costs and risks entailed by PPPs for the government.

Fiscal Risks and Fiscal Accounting: Eurostat



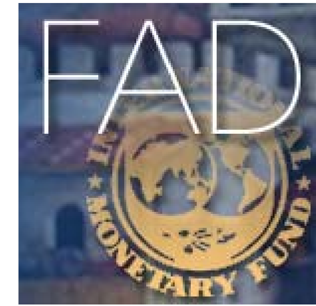
- Eurostat decision of 2004: PPPs should be classified as private investment if the private partner bears most of the construction risk, and of either availability risk or demand risk.
  - General problem: Since the private partner typically bears construction and availability risk, most PPPs are likely to be classified as private investment, even though the government may bear many other risks.
  - Specific problem: these rules are applied in a context where governments are trying to minimize fiscal deficits and debts, to meet SGP targets.
- Eurostat rules, plus the incentive to show low deficits, may result in:
  - Some projects being done as PPPs just to classify them as private, even though the government may bear sizable risks.
  - Some projects which are well suited for PPPs being designed suboptimally just so they can be classified as private.

Fiscal Risks and Fiscal Accounting: Eurostat (continued)



- Implications:
  - Contingent liabilities for the public sector arising from investments that are not on the public sector's books
  - Budgetary rigidities, as future revenues are in fact being pre-committed, without this being evident in the balance sheet
- Eurostat rules reduce the likelihood that PPPs are carried out for the right reason, i.e., to capture efficiency gains.

Fiscal Risks and Fiscal Accounting: The IMF Proposed Approach

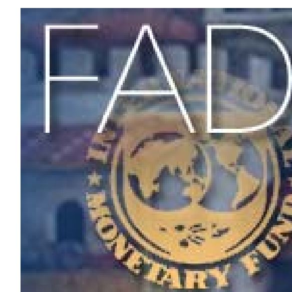


- Approach proposed by the IMF aims at mitigating incentive problems and clarifying fiscal implications of PPPs, *even when they are classified as private*:
  - Emphasis on the comprehensive disclosure of the known and potential future costs of PPPs for the public finances.
  - Incorporation of these costs into medium-term budgetary projections, and into the assessment of medium-term public debt sustainability.

Fiscal Risks and Fiscal Accounting: Disclosure

- For each PPP project or group of similar projects, information should be provided in the budget documents on:
  - Future payment obligations of each partner, certain and/or contingent, for the following periods: 1–5 years; 5–10 years; 10–20 years; over 20 years.
  - Significant terms of the project that may affect the amount, timing, and certainty of future cash flows, valued to the extent feasible.
  - Contract renewal and termination options.
  - Obligations to provide, or rights to expect, provision of services.
  - The nature and extent of rights of each partner to use specified assets.
  - Any arrangements to transfer specified assets at the end of the concession period.

Fiscal Risks and Fiscal Accounting: Disclosure (continued)



- Whether the PPP assets are included on the government's balance sheet, and how the project affects the reported fiscal balance and public debt.
- Whether the PPP assets are included either on the balance sheet of special purpose vehicles, or in the private partner's financial statements.
- Any preferential financing for PPPs provided through government on-lending or via public financial institutions.
- Future expected or contingent government revenue, such as lease receipts, revenue or profit-sharing arrangements, or concession fees.
- Any project financing or off-balance sheet elements involving entities owned or controlled by government.

Treatment of PPPs in Medium-Term Fiscal and Debt Scenarios

Bringing PPPs into medium-term scenarios

- **For PPPs that are classified as private:**
    - Future payments by the government under PPP contracts and expected future costs of guarantees should be counted as primary spending in medium and long term fiscal projections
    - The potential costs of the contingent liabilities associated with PPPs should be explored with multiple scenarios and stress tests
- **For PPPs that are classified as public:**
    - Register investment as public spending and its financing as public debt upfront
    - Clearly separate the future payments by the government into its economic components.
        - Those for services provided on an ongoing basis as primary spending,
        - Those representing costs of financing as interest,
        - The rest as amortization of the financing implicitly provided by the private partner
    - Work with multiple scenarios.