The Promise — and Pitfalls — of Partnerships

Abstract

Public-private partnerships (PPPs), now a major business model for private participation in service delivery around the world, are agreements whereby the private sector supplies infrastructure and related public services normally provided by the government. Under a PPP, the government does not own the required assets (or infrastructure), but buys the flow of services over time from the private partner. The allocation of project risks between the private firm and the government is a crucial part of the agreement to ensure the value for money. In principle, risks should be allocated to the party that is best able to mitigate or absorb them.

In developing countries, however, the combination of risk and reward is often unattractive. Private partners generally seek fiscal support (government guarantee or subsidies) to enhance commercial viability of projects. Such measures help increase the likelihood that large-scale and complex projects will materialize, but they are also costly to the taxpayers and often erode the value for money. To realize the full potential of partnerships, governments need to consider alternatives, such as sharing some of the risks or mitigating them through policy action, before granting fiscal support.

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In 1991, the British Government decided to implement the Channel Tunnel Rail Link (CTRL) Project as a public-private partnership*2 (PPP). It was to be the first new railway in 60 years and cost $8.2 billion to connect Central London with the Channel Tunnel. International bids were invited for the concession to design, build, finance, own and operate the rail link. The contract was awarded in 1996 to London and Continental Railways Ltd (LCR), a special purpose vehicle owned by eight private firms. Design and preparations started in 1996; construction began two years later.

Major technical and financial difficulties soon arose*3. The forecast of passengers and revenues turned out to be much too optimistic. Financial distress forced some of the private partners to withdraw. The deal was restructured twice, with the government coming to the rescue by guaranteeing most of the construction loans and agreeing to lend more money as needed during the operational phase. The commercial risk that was meant for private firms ended up in the government’s hand.

Despite the travails, much has since been achieved. The rail link was completed and launched as envisaged in November 2007. It is an engineering marvel – 109 km of rail for the country’s first high-speed trains, with 4 km of elevated track and major bridges, 37 km of tunnel and 117 supplementary bridges. For travelers, the new link saves about one hour on the trip from London to Paris or Brussels.

The CTRL is a useful example of partnerships. As one of the earliest projects, it involved unfortunate missteps and mistakes made by both the government and private partners, even when substantial political will and institutional support was in place. It provides an illustration of the challenges inherent in this approach to service delivery.

I. What is a partnership?

A public-private partnership is the arrangement whereby the government contracts to purchase services from the private sector on a long-term basis, often between 20 to 30 years. The private sector builds and maintains infrastructure in order to deliver the designated services. The contract period involves a construction phase followed by an operational phase when services are delivered. The government pays no expenses until service delivery begins.

The private parties contracting with the government are usually a special purpose vehicle, set up specifically to implement a PPP project. See Chart 1 below. It is responsible for developing the overall plan to meet the contractual obligations. Project finance involves a mix of equity and debt with limited recourse. The ratio of debt to equity – often a subject of intense negotiations between lenders and project sponsors – is generally between 80/20 and 90/10 as far as partnerships are concerned. Banks and institutional investors play a crucial role in providing funds and financial advice.

During the operational phase, the company receives a fee from the government or from consumers. See Chart 2 below. This fee covers operating expenses, debt service and a return to private shareholders. Payments of the fee are contingent upon satisfactory delivery of the

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*2 The expression used was “private finance initiative” (PFI), a term later changed to PPP in 1998.
*3 Select Committee on Public Accounts (2006)
stipulated services. If performance falls below the agreed standards, the fee may be reduced or suspended. Such output-based contracts give the private sector an incentive to mobilize managerial skills and resources in the cause of public service.

At the heart of PPP is the allocation of risks. Initially, the government may wish to assign most of the risks to private firms through specification of services and technical requirements in its tender documents. The resulting offers and pricing, however, may lead the government to reconsider. Furthermore, senior lenders, who can make or break a deal, generally play a key role in influencing the ultimate assignment of risks.

A partnership differs significantly from public-sector provision or traditional methods for involving the private sector, as with a franchise or concession. These mechanisms give the private sector exclusive rights to supply goods or services in markets where unfettered competition is not possible. A concessionaire or franchisee, like independent power provider or toll road operator, operates much like a normal business, except for regulatory rules governing price changes and service quality. But when consumers do not pay the full price, as with a prison, hospital or school, these traditional mechanisms do not work. PPPs thus have broader applicability. They also require closer relationships among partners and greater mutual reliance.
II. Value for money

Governments often wish to meet public demand for better infrastructure without imposing the burden of more debt or taxes. Partnerships offer a solution. By relying on private finance to acquire new assets and paying for the services over time, governments can bypass the need to borrow. In some cases, however, the PPP scheme is also used to circumvent expenditure limits by moving public investment off the budget and public debt off the balance sheets. But these practices are aberrations, rather than the rule.

The main justification for implementing partnerships, however, is the potential to create *value for money*. Value for money is achieved when service quality improves without increasing the cost or when service quality is obtained at a lower cost. See Box 1. In most countries, the potential value for money is reviewed and tested before a PPP project is approved. The review procedure used to screen out projects varies across countries. In the Netherlands, for instance, it has four logical steps:

- An outline of procurement options, including traditional option and PPP;
- A qualitative analysis showing financial implications of alternative options;
- A quantitative analysis of cost, benefit, and rate of return of each option;
- A final report concluding whether the proposed PPP offers value for money.

According to independent research, PPPs show considerable promise. In the UK where

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**Box 1: Drivers of Value for Money**

Where does the value for money come from? Experts attribute the benefits of PPPs to the following factors:

- **Specification of outputs.** The private party is paid on the basis of services delivered (output). The contract spells out the timing, conditions and quality of services, with agreed performance indicators. This output orientation is an improvement over the traditional emphasis on input.

- **Whole-life perspective.** Long-term PPP contracts (20–30 years) make it possible to integrate all cost components, including design, construction, operational and maintenance costs, creating synergies and new cost-saving solutions.

- **Competition.** Competitive bidding in procurement (selection of private partner) allows the government to rule out weaker candidates and high-cost solutions.

- **Good risk allocation.** The key is to assign each risk to the party best able to mitigate it or absorb the impact. Some risks need to be borne jointly. Certain risks, as with taxes or price control, should remain with the government. Most risks, however, should be transferred to the private party. For example, a reasonable allocation for some of the projects might be as follows:

<table>
<thead>
<tr>
<th>Retained risk</th>
<th>Shared risk</th>
<th>Transferred risk</th>
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<tbody>
<tr>
<td>Procedural risks</td>
<td>Force majeure</td>
<td>Design/Technical risk</td>
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<td>Inflation risk</td>
<td>Demand risk</td>
<td>Financial risk</td>
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<td>Regulatory risk</td>
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<td>Construction delay</td>
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<td>Political risks</td>
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<td>Operating performance</td>
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<td>Residual value risk</td>
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* IMF (2004)
extensive evaluations have been conducted by the HM Treasury and National Audit Office (NAO), the track record of PPPs compares favorably with those of traditional projects. The NAO reported that 76% of the PPPs were delivered on time, compared to 30% of the non-PPP projects. Similarly, 79% of PPP projects and only 27% of non-PPP projects were delivered within budget. See Chart 3 above. In addition, independent experts found that PPP projects made use of good design and construction material which led to better buildings and lower maintenance costs.

The performance of PPP projects during the operational phase also shows similar results. According to a survey of stakeholders, 81% of respondents found the performance satisfactory (29%), good (46%) or excellent (6%). In addition, 76% rated the performance "as well as expected" (35%) or "exceeding expectations" (41%).

III. Guarantees and subsidies

In emerging markets where project risks are high, it is often difficult to ensure the value for money. Prospective private partners are scarce while the demand for fiscal support – guarantee, subsidies and tax breaks – is strong. Not providing the assistance could dampen investor interest and limit the prospect of the desired project. But if help is given it could turn out to be very costly, undermining the goal of achieving value for money. Managing the demand for fiscal support is clearly a delicate task.

Governments often see a compelling reason to assist the private sector. For one thing, the investment being sought may serve key economic or social objectives. The intended service may involve a positive externality, as with basic education and water, which provides justification for a subsidy. In other cases, the risk faced by the private sector may be considered insurmountable or too costly to mitigate. The Trans-Harbor Bridge in Mumbai, for instance, is considered not feasible without a large subsidy (about 30% of project cost or $300 million).

Since 2004, India has provided through fiscal budget – a facility to help bridge similar “viability gaps” in infrastructure projects.

With social or political pressure on the government, getting the investment may become a priority, and not proper review or finding the best solution. Often the authorities decide to grant fiscal support on the ground that no im-

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**Chart 3: Comparing PPP and non-PPP**

![Chart 3](chart3.png)


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* 8 World Bank (2006)
mediate cash is required, without considering the expected loss over the (very long) life of contract. Indonesia’s guarantee scheme, for instance, seemed cheap when granted but soon proved very costly; in one power project, the government paid $260 million when the guarantee was called. Governments may also bypass the opportunity to mitigate risks. For instance, when inflation and price control are the main issues, the authorities are in a position to address them through economic policies without relying on subsidies or guarantee.

More generally, fiscal support is just one – and not necessarily the best – option at the government’s disposal. Investment barriers may arise from causes unrelated to market failure for which fiscal support is well suited to address. The government, however, may not adequately consider all the alternatives. For example, policy reforms involving tariff adjustments may be just as effective as – and less costly than – providing a revenue guarantee for independent power providers.

Making the right choice is a challenge. In principle, the question should not be posed so narrowly as: to help or not to help, as is often the case in practice. The real question is how best to achieve the underlying policy objectives. Finding the solution involves a decision tree with multiple tiers of questions. Above all, the government will need to consider different approaches, including retaining some of the risks or implementing reforms, in addition to providing financial assistance. Where the risks originate from the public sector, as with exchange control or expropriation, the government is best placed to absorb – and mitigate – them. Where financial assistance is warranted, the expected loss should be taken into account, rather than the cash outlays. In particular, the probability and magnitude of loss under the contract will need to be examined. Once a decision is made to grant fiscal support, transparency calls for adequate documentation and disclosure.

### IV. Concerns and criticisms

Where PPPs are introduced, controversy often follows. The concerns are frequently voiced by trade unions, academics and the media. Some of the criticisms are valid, but many are not, as indicated below. Nonetheless, the debate that follows has served to clarify the issues and contribute to improvements in PPP projects.

**Hidden public debt.** Assets acquired through partnerships are often on the balance sheet of private firms. If the risks of ownership are also borne by the firms, this practice is consistent with generally accepted accounting principles. However, where the guidelines are not sufficiently rigorous, public agencies may use partnerships to hide assets under their control. (In accounting terms, a "financial lease" could be disguised as an "operating lease.") This concern is not out of place. In the UK where the guidance is clear, cases of "disappearing assets" (or "orphans") remain. According to the NAO, a survey in health and local governments found that, in 24 out of 27 PPP deals, the assets were not included on the balance sheets of either the government or private firms.*

**Impaired accountability.** The concern is that PPP contracts may be incomplete, or not sufficiently robust. The government may not be able to adequately specify in advance the output and service quality under varying circumstances. Without clear definition, the private partner
may be able to change service quality with impunity. The long-term nature of contracts exacerbates this issue. Proponents of PPPs call for more transparency in the review process and disclosure of agreements, as well as ex-post evaluations by independent parties. The resulting input of more stakeholders may improve the specification of output. Over time, however, improved accountability will require periodic reviews of contractual provisions.

**High borrowing cost.** According to critics, no PPPs can deliver value for money since private firms borrow at a higher cost than government. While private partners do pay higher interest rates on borrowed funds, this criticism is still invalid. It fails to recognize that financing cost is one component—often one third or less—of total cost. There is considerable scope for cost saving, in spite of a high borrowing cost. Independent reviews show that PPPs do deliver value for money, as discussed above.

**Adverse impact on civil service staff.** It is at times alleged that cost saving under PPPs has come at the expense of civil service staff, who lose their jobs or part of their income. This criticism is not generally correct, however, since it ignores innovations and other drivers of value. Nonetheless, some of the PPPs did involve staff cuts and changes in the terms and conditions of service. In many countries, including the UK, safeguards have been built into the guidance and PPP standards to protect the interest of civil service staff.

**Loss of flexibility.** The charge is that partnerships use today’s solution to deal with problems of the next 30 years. With respect to infrastructure, this criticism applies equally to traditional public provision as it does to PPPs. Furthermore, sophisticated partnerships include built-in flexibility to respond to changing circumstances. Periodic exercises in benchmarking and market testing, now common in contracts, enable the government to benefit from technological advances and new solutions in services.

### V. Global spread

Despite the concerns expressed, PPPs have enjoyed considerable success. From a modest beginning in the 1990s, it has grown rapidly to become a major policy instrument around the world, involving more than 200 deals with over $50 billion of capital in 2006. Industry experts believe the rising trend will continue for many years.

Partnerships between the private sector and government agencies have a long history. In the 19th century, French cities, including Paris and Lyons, awarded long-term contracts to a private firm (Compagnie Gereale des Eaux) to supply water. In the US, correctional facilities have often been built and operated by private firms. Since the 1970s, Hong Kong has relied on private firms to build toll roads and tunnels.

But modern partnerships have their origin in the UK. Launched (as PFI) by the Conservative Government in 1991, it was embroiled for many years in controversy. The government, however, persisted, implementing a few partnership projects. Following the General Election of 1997, the new Labour Government maintained the existing portfolio and added new projects. So far, the PPP model has raised more than $100 billion of investment on more than 700 projects in all sectors, including 185 new or refurbished health facilities, 230 schools and 43 large transport projects. Currently, almost 20% of public investment is carried out through PPPs.

The experience of the UK has generated strong interest and considerable following. Among the most advanced countries are Australia, Ireland, Spain, France, Canada and the US. Meanwhile, Finland, Norway, Germany, Ja-
pan, Italy, the Netherlands and Portugal have seen a growing share of PPPs in public investment, especially at the sub-national levels.*10 Ireland has seen a very rapid spread and growth of the practice after deciding to adopt the PPP model in 1998. In just five years, more than 130 PPP projects were implemented, raising more than $10 billion of new investment.

Among developing countries, South Africa, Mexico, Chile, Korea and Czech Republic are relatively active, many more, including Pakistan, India and Tanzania are exploring or setting the stage for introduction. In Korea, PPPs grew from almost nothing in 1998 to account for $2.7 billion of capital or 14% of public investment in 2005, with the transport sector accounting for 71% of the total. Chile was particularly successful. Motivated by a desire to fill a large infrastructure gap without weakening its fiscal position, the government started engaging the private sector in 1994. Ten years later, the mission was accomplished, with more than $5 billion of investment in 36 projects, including 24 in transport, 9 airports, two prisons and a reservoir.

Early partnerships were often implemented as stand-alone and relatively large projects, mostly in the transport or energy sector. As activity rises, more sectors become active, especially health and education. Experience shows that over time PPP markets become more sophisticated, with deeper know-how and broader supporting services including consulting, legal and accounting. See Chart 4.

*10 CBI (2007)
VI. Lessons of experience

Before embarking on the road to PPPs, policymakers might find it useful to consider the following guidance:

1. Give the private sector a chance by creating a level playing field. In the early days of partnership development, resistance of public agencies is often strong, making it difficult to achieve a level playing field, unless significant efforts are made. Incumbent contractors or public agencies are given many advantages over private-sector competitors, creating a barrier to entry, as well as a mistrust of private firms. To counter this tendency, the UK has striven to achieve “competitive neutrality” which requires that competition should be conducted in a way that is fair to all concerned. The government takes on the responsibility to ensure fairness in both competitive markets (through competition policy) and in public sector procurement (through competitive neutrality). Germany and Japan have also adopted this approach. In New Zealand, a separation between policy advice and service delivery has been observed since the 1980s. To prevent the capture of public funds, any agency engaged in service delivery is not permitted to set or influence policy.

2. Build the capacity for planning and procurement in public agencies. In developing countries where skills are in short supply and corruption is not, this is an area of particular challenge. It’s essential to create or move toward a professional civil service that is well paid and recruited on the basis of merit-based competition. In addition, the business model for public procurement needs to focus more on results, or the services rendered to taxpayers, rather than cost minimization or contract compliance. Furthermore, collaboration between public agencies and private firms should be actively promoted to facilitate learning and transfer of knowledge.

3. Establish clear standards and guidelines on disclosure and fiscal reporting, especially with respect to criteria for keeping PPP-funded assets and debt off balance sheets. Where risk transfer to the private sector is limited, the assets and debt need to be kept on the government’s balance sheet. Specific tests have been developed and applied. The EU, for instance, requires the assets to be on the government’s balance sheet, unless two conditions are met: (i) the private partner bears the construction risk; (ii) the private partner bears either the availability risk or demand risk.

4. Assess the capacity and constraints of the markets. To make PPPs work, it’s also crucial to look beyond the public sector. Before tendering begins, the government needs to undertake supplier assessment to understand the potential of prospective partners. This engagement will help the government get a better idea of what the market can deliver. In some cases, broader reform and liberalization may be needed, including allowing the entry of foreign firms, or preventing the use of market power by dominant firms or state-owned monopolies.

5. Maintain adequate deal flows (pipelines of partnership projects). To encourage active private participation, PPPs should not be seen as one-time events or a passing fad. Instead, they should be regarded as a new business model that is growing over time. Public announcements alone will not be enough. More credible is the mobilization of efforts in public agencies to prepare PPP projects and expand the pipelines. To accomplish this goal, the support of political
leaders is indispensable. This Irish experience is highly relevant in this regard. See Box 2 above.

6. Foster innovations that arise through partnerships. An important lesson is not to stifle innovations which naturally arise in partnership projects. The client focus and output orientation inherent in PPP deals tend to facilitate service improvements, in contrast to the cost minimization approach common in traditional practices. In addition, the whole-life perspective arising from combining asset development with service delivery makes it possible for firms to reduce costs and improve services. Furthermore, the competition required in the selection of PPP partners forces candidates to innovate and create value for taxpayers.

7. Do not reinvent the wheel. Instead, build on what other countries have tried and tested. Complex deals like PPPs can easily go wrong. It makes sense to avoid costly mistakes by finding what has worked elsewhere and adapting it as needed to local conditions. In fact, the UK, which has been a pioneer in this field, has learned much from other countries, including the contracts for prison services in the US.

**VII. Conclusions**

Public-private partnerships (PPPs), now a major business model for private participation in service delivery around the world, are agreements whereby the private sector supplies infrastructure and related public services normally provided by the government. Under a PPP, the government does not own the required assets (or infrastructure), but buys the flow of services over time from the private partner. The allocation of project risks between the private
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