Basic conditions for a successful PPP

A PPP can offer interesting benefits to both public and private sectors, but it does call for a business-like approach on the part of the government and active input on the part of the private sector.

- Output-oriented working
- Broad scope
- Collaboration based on clear agreements

Output-oriented working

For a PPP to have a prospect of success, 'output-oriented' working is essential. The government must not yield to the temptation to lay down all the details of the project in advance: that merely reduces the private sector to the status of a contractor. To make the best possible use of the knowledge, experience and creativity of the private sector, the government does not specify assets as such, but what services in assets should be capable of delivering. Within this specification the government must then leave room for the private sector to fill in the details in its own way.
For example: in a PPP project the government does not simply buy a stretch of motorway from A to B, it buys traffic capacity from A to B for a stated number of years. This gives industry an opportunity to come up with alternative solutions which will achieve the same goals but at the same time will accord better with the wishes and needs of the private sector parties. Naturally the government will have to set out clear requirements and conditions. Standards by which performance may be judged will need to be established so that the private sector parties are remunerated only to the extend that these performance standards are met, and of course the government is under an obligation to spend public funds in a way that is democratically accountable.

Broad scope

It is not only in establishing product specifications that room must be left for private sector input: in determining the overall range or scope of the project, too, the government must avoid setting excessively onerous limits. By integrating several projects or parts of projects it is sometimes possible to achieve greater overall harmony leading to added value. If the government wishes to build a railway station, for example, it should be possible to

cooperate with the developers of, say, offices near the station. Both parties have interests which have a common basis and which will be better served if they can work together.
Broadening the scope of a project can have the effect of attracting funding from other parties which can realise their own interests through participation. Ultimately this process of 'value capturing' leads to increased total financial resources, which again can be of benefit to the quality of the project. Of course, there are limits to how broad the scope of a project can be: its complexity and size must not render it unmanageable.

- **common interest**
- **public interest**
- **democratic control**
- **even balance**

Common interest

For the government, then, the benefits of a PPP are clear: a project can gain in quality if the government consults the private sector at an early stage on the best way of achieving a particular goal. A PPP may also bring in extra financial resources for projects serving the public interest. But the private sector too stands to gain from a new way of collaborating with government. The wishes and needs of the market can be better accommodated in government projects if there is collaboration at an early stage. Because projects are carried out more efficiently, the savings made can be put to good use in funding other projects. And of course the likely profitability of the exploitation phase is a powerful incentive for taking part in a PPP.

The decision whether or not to carry out a project in partnership with the private sector is for the government to take, and depends on many factors. Naturally it is also possible for private sector parties to take the initiative and approach the government with proposals.

Public interest
In the past, both public and private sectors have displayed a degree of inhibition in respect of joint projects, as they have very different responsibilities and very different interests. Ultimately, the interest of

private sector companies is commercial: if there is no money to be made — whether it is in the short term or the long — there is no incentive for a company to embark on a project. This is precisely why projects which can never be profitable but which serve the public interest are the province of the public sector. Conversely, the government will always be inclined to draw back from projects in which market forces operate. Only where market forces mean that people or matters of the public interest stand to lose will the government attempt to regulate the market. Naturally, commercial organisations also have a certain social responsibility, but it is always limited by the need for profitability.

Democratic control

The public and private sectors operate in different ways. For example it is not whether money can be made but whether the political will exists that decides whether a railway line will or will not be built. Government and Parliament will always arrive at any decision involving the investment of public funds on the basis of a holistic weighing up of the interests. The responsibilities and powers of government, Parliament and those with a legitimate voice together constitute the starting-point for embarking on a Public-Private Partnership.

Democratic control is an essential part of the public domain and is thus also wholly applicable to PPP projects. Decision-making procedures enshrined in law, such as the Transport Routeing Act, environmental impact reporting and the Key Planning Decision procedure, must be followed at all times.

In a democracy, political balances can shift and decisions can be altered with changes of government. Politically sensitive projects are therefore less suited to implementation through a PPP.

Even balance

Government and the private sector, then, have differing goals and responsibilities. The private sector is sometimes doubtful of the dependability of government as a business partner. Conversely, the government is cautious about PPP relationships with the private sector because it can always be held to account for its public responsibilities. An even balance of tasks and risks should ensure that any PPP uses the taxpayer's money in a responsible way. The government must never lose sight of its chief duty: to serve the public interest. In short, the partnership between public and private sector is a matter of give and take. Government and private sector sometimes have opposing interests, but often too they have a common interest. It is only when both parties respect each other's position and are aware of each other's possibilities and limitations that a public-private partnership can be successful.

Collaboration based on clear agreements

Right from the outset of a PPP there must be absolute clarity about the input, tasks and responsibilities of all parties. The PPP Knowledge Centre has developed a number of policy instruments designed to steer the collaboration in PPP projects in the right direction.

- process architecture
- contract management
- risk management
- financial instruments

Process architecture

For each individual project it will be necessary to examine what will be the most suitable form of collaboration and on what agreements it will have to be based. At each stage of the project it will be necessary to find a balance between the degree of government control and the substantive involvement of the market. A good process architecture, tailored to the individual project, is necessary to bring and keep the parties together. In each phase of the project it must be perfectly clear what the goal of the collaboration is and how the parties' authorities and risks are divided. It must also be possible to fine-tune the process as it proceeds at the basis of predefined decision points.

Contract management

The form that the contract between the parties should take depends on many factors. It may be that different agreements have to be arrived at for different phases of the project. Certainly, however, tight contract management is essential throughout the project. The basic premise here is that a checklist must be established clearly stating which party is responsible for each individual activity in each individual phase and the manner in which each party's performance will be evaluated.

Risk management

Because in a PPP project all arrangements are set out in contracts, it is clear at all times which party bears which risks and how the parties should be remunerated for their performance. Watertight risk management at every stage of the project — again, on the basis of a checklist — is necessary both to ensure that the project is kept on track and to avoid unforeseen circumstances.

Financial instruments

Financial arrangements must be attuned to the nature and size of the project. The government has a number of financial instruments at its disposal for achieving this. The selection of the most suitable financial instrument will depend not only on the extent to which it will enable the government to share in any profit, but also on how individual instruments affect the way tasks and risks are divided and the input of other parties. For example, subsidies may increase the likely profitability of a project and thus make it more attractive to private sector investors.

Subsidy

A subsidy is a one-off or periodical financial contribution by the State which is granted under stated conditions. The State uses subsidies to reward the recipient for incoming costs which have no direct financial benefit, but which can have social benefits or to encourage the recipient to undertake (or not undertake) certain stated activities. Where a subsidy has been granted, the State will ensure that the recipient fulfils the conditions under which the subsidy was awarded. Subsidies reduce the risk for all capital providers and have a beneficial effect on the return for equity providers.

Subsidy with clawback

Clawback may be defined as the recovery of money by taxation or penalty. A subsidy granted subject to a clawback clause is thus one which, under certain defined conditions, can be repayable to the government in whole or in part. A clawback clause may be useful where there is significant uncertainty as to what the future profitability of a project will be. Where the ultimate deficit is lower than expected, the government will naturally seek to recover some or all of its subsidy.

Availability fee

An availability fee is a sum paid in remuneration for making a good or service available. The output needs to be carefully specified. An availability fee differs from a subsidy in that first the good or output is delivered, after which the remuneration is awarded. This form of remuneration is often used with concessions.

Usage fee

With a usage fee, the basis for the granting of remuneration is the actual use made of the product or service. Usage fees are employed in concession models. The remuneration can be paid by the user, as when a toll is levied, or by the government through a shadow toll mechanism.

Guarantees

Guarantees are employed to reduce the risk for investors and financiers. A guarantee may relate to either the financial commitments or the revenue in a PPP, or both. The financial commitments guaranteed may include the payment of interest and the repayment of loans. A take-up guarantee reduces the commercial risk by guaranteeing a certain income stream into the project.

Loans

By granting a loan the State provides a project with funds for a predetermined time against a charge which does not depend on the results of the project. Repayment of loans may be in a single payment or in tranches. The rate of interest affects the return on the equity provided by risk capital providers (shareholders). For example, borrowing at easy terms (i.e. at a rate below the market rate) will improve the probable return on shareholders' equity.

Subordinated loans

The interest and repayments on a subordinated loan are subordinated to those on ordinary loans. A subordinated loan reduces the risk to other lenders, so that capital can be attracted under more favourable terms. For this reason, a subordinated loan counts as guarantee equity.

Shares

Shares are the riskiest of all financing instruments. When revenues come to be distributed, the shareholders are always the last in line (after lenders and other creditors). In exchange for this position shareholders have a say in the project and the right to all income remaining when the other financiers have all been paid. If the results are good, the shareholders will receive a higher remuneration than other financiers. If they are bad, it is possible for the shareholders to end up with nothing. Where shares are to be held by the government, it must be remembered that the return-on-equity expectations for other providers of risk capital do not improve, since the government participates on the same conditions as other shareholders and will have the same claim to the return on equity.