

**Exposing the myths around Public-Private Partnerships
A PSIRU Briefing for EPSU
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Introduction

Public-private partnerships (PPPs) are not the answer to public finance constraints. This updated briefing from the Public Services International Research Unit (PSIRU) highlights the serious financial and operational problems that have arisen with PPPs. The information draws on a wide range of empirical studies, and refers in particular to evidence from parliamentary enquiries on PPPs in the UK, which accounts for a very large percentage of European PPPs and the longest period of experience of PPPs. It also includes some of the negative experiences of several of the PPPs that were included in a European Commission Resource Book on PPPs published in 2004 and whose effectiveness can be better assessed after 10 years of operation. The conclusions are clear and contradict much of the official thinking on PPPs. The 11 key facts are:

- 1 The private sector doesn't assume the risk
2. PPPs don't guarantee better value for money.
3. The normal public sector option is not always considered
4. PPPs are not better at finishing projects on time or on budget than ordinary contracts
5. The rules on PPPs don't ensure complete transparency and can contribute to corruption
6. Any competitive tendering associated with PPPs does not guarantee savings
7. PPPs don't ensure better design innovations
8. The private sector is not necessarily more efficient at running services
9. The private sector cannot raise money more cheaply than governments
10. PPPs distort public policy priorities and load austerity policies onto other services
11. PPPs are not necessary to solve the problems of countries in crisis.

1. The private sector does not assume the risk

The rules established by European Union's statistics agency, Eurostat, say that a PPP can be treated as not increasing government debt as long as 'construction risk' and 'availability risk' are transferred to the private sector. This just means that the asset has to be built and stay in working order. These are very weak tests: the International Monetary Fund (IMF) says that the "Eurostat decision on accounting for risk transfer gives considerable cause for concern, because it is likely to result in most PPPs being classified as private investment... [and so] provide an incentive for EU governments to resort to PPPs mainly to circumvent the Stability and Growth Pact (SGP) fiscal constraints."¹

In practice this means that if a school is built under a 30 year PPP, and after 10 years it is no longer needed, the public authority has to keep paying the company for the next 20 years, regardless. This actually happened in the UK, in a school in Northern Ireland.² 'Demand risk' is often a more substantial risk than 'availability risk,' and it should be transferred.

However, risk cannot be transferred to private companies for nothing. Companies will always require extra payment to accept extra risks: "one should certainly not expect profit-maximising private sector firms to assume this risk without compensation, and indeed they do not. The more risk that is transferred, the more expensive it is likely to be risk is transferred, not necessarily reduced."³

The UK Government, in spite of so much experience with PPPs (often called PFIs in the UK) has not built up any expertise of its own to assess risk and deal effectively with PPP contracts: "Departments should have developed commercial experience from using PFI but we still see some examples of projects and contracts which are clearly lacking in commercial awareness."⁴ PPP units do not have any responsibility for evaluation. They promote PPPs, but have no responsibility for the results.

This can be seen in other European PPPs, such as the M1-M15 Motorway in Hungary. As a result of public discontent due to high tolls, road users took legal action against ELMKA Rt, a private company which brought together construction and toll road operators. Once open, the volume of traffic was lower than estimated and this resulted in lower revenues, which led to financial problems for the company.⁵ It was taken over by the public sector when traffic volume was 50% below projected levels. The private sector partner's lender refused to finance the completion of the motorway.⁶

2. PPPs don't guarantee better value for money

The Eurostat rules are only a way of deciding whether the asset and debt of a PPP is scored on the government's balance sheet. Eurostat does not carry out a value for money assessment of PPPs. These are different issues: "whether PPPs offer better value for money than conventional procurement is a quite separate question from that of accounting treatment".⁷ PPP proposals are normally compared with some 'public sector comparator' before being authorised, but these comparisons have been the subject of much criticism by academics, auditors and parliamentary committees.

UK parliamentary reports have found that these comparisons have been badly done, not exposed to proper challenges and debate, and been systematically biased in favour of PPPs: "The use of PFI has been based on inadequate comparisons with conventional procurement

which have not been sufficiently challenged.”⁸; “...we are concerned that the value for money appraisal system is biased to favour PFI. Assuming that there will always be significant cost over-runs within the non-PFI option is one example of this bias. The Treasury should seek to ensure that all assumptions in the value for money assessment that favour PFI are based on objective and high quality evidence.”⁹ Public auditors in the Netherlands and elsewhere have also questioned whether such comparators are adequate.

Most assessments are flawed because they do not carry out a cost-benefit analysis comparing the proposed PPP, an alternative using normal procurement, and the third option of doing nothing. This requires including the external impacts, for example on employees. But: “as yet, no government has performed normatively appropriate analyses of PPPs. Evaluation of PPPs should be performed by arms-length analysts, either inside or outside government.”¹⁰

In the period 2009-14, 92.5% of Scottish Water’s capital programme was delivered by private contractors. Scottish Water set up Scottish Water Solutions with private sector partners (Stirling Water and UUGM), retaining 51% ownership in 2003. The partners are owned by utilities and construction companies. Stirling Water is owned by Thames Water, Gleasons, KBR and Alfred McAlpine and UUGM is owned by United Utilities, Galliford Try, and Morgan Est plc. The capital programme was handed over to the partners to deliver, including designing, managing, costing and implementing the construction work.¹¹ In 2010-11, the Water Industry Commission, a pro-privatisation group, criticised the programme as being poor value for money.¹² In 2010-11, about 30% of an average water bill went on operating profit (not including tax, net interest and dividends).¹³

In the UK, the expected tax revenues are treated as an added benefit of PPPs, but in practice there is no monitoring, and many of the owners are based in tax havens: “Some PFI investors reduce their exposure to UK tax through off-shore arrangements. Yet the Treasury assume tax revenue in their cost-benefit analysis of PFI projects. The Treasury could not tell us if PFI investors had paid tax in the UK on profits and on equity gains, or whether corporation taxes had been collected from PFI companies. The public sector has insufficient information on the returns made by PFI investors and no mechanism for sharing in gains when the investors sell their shares.”¹⁴

Governments avoid spending money monitoring contractors. Even in the UK, which has the biggest and longest programme of PPPs, the Government has not carried out a systematic evaluation of results: “There has not been a systematic value for money evaluation of operational PFI projects by departments. There is, therefore, insufficient data to demonstrate whether the use of private finance has led to better or worse value for money than other forms of procurement.”¹⁵

3. The normal public sector option is not always considered

In practice, normal public sector procurement is not an option because it would show an increase in government debt, whereas PPPs conceal this. So a PPP becomes the only option. In the UK: “For too long PFI has been the 'only game in town' in some sectors which have not been provided with adequate capital budgets for their investment needs...If PFI is the only option for necessary capital expenditure then it will be used even if it is not value for money.”¹⁶ In Ireland, the government preference for PPPs: “led local authorities to reject its

own value for money assessments or preliminary reports where they were found to favour traditional procurement methods.”¹⁷

The Wijkertunnel Randstad in the Netherlands, shows that ignoring the public sector option can result in higher costs. The procurement cost of the tunnel was 41% more expensive than a public sector alternative. There were major problems in the tendering process. The National Audit Court ruled that the tendering process should not have continued when there was only one bidder. The lack of experience of the government in assessing the value for money of the PPP bid and the real costs of government provision resulted in the high costs of procurement.¹⁸

4. PPPs are not better at finishing projects on time or on budget than ordinary contracts

PPPs use ‘turnkey contracts’ which means no money is paid until the project is completely ready. These are much more expensive than ordinary contracts: a European Investment Bank (EIB) report found that PPP road contracts across Europe were on average 24% more expensive.¹⁹ If it is important to transfer construction risk, this can be achieved by using a turnkey contract in normal procurement, without having a 30 year PPP.²⁰

The Apa Nova water project which was PPP between City of Bucharest and Apa Nova (part of the utility multinational Vivendi) shows that PPPs are not better at finishing projects on time or on budget. It failed to complete a €60 million sewer project as well as causing 17 increases in consumer prices²¹ and being involved in contract violations.^{22 23}

Also, if you take account of the whole process including negotiating the contract, then PPPs often take much longer than traditional procurement. In the UK “there is no convincing evidence to suggest that PFI projects are delivered more quickly and at a lower out-turn cost than projects using conventional procurement methods. On the contrary, the lengthy procurement process makes it likely that a PFI building will take longer to deliver, if the length of the whole process is considered.”²⁴

Furthermore, the construction phase is only one part of a PPP, which often lasts 30 years. Whatever the contract says, it will often be renegotiated, and the expected costs can increase significantly: “In the UK, renegotiations occurred in 33% of PFI projects signed between 2004 and 2006. The changes amounted to a value of over \$4m per project per year equivalent to about 17% of the value of the project”²⁵.

5. The rules on PPPs don’t ensure complete transparency and can contribute to corruption

The contracts associated with PPPs are often for long periods and provide opportunities for companies to win a stream of government backed revenue lasting for 25 or 30 years. This creates huge incentives for corruption, both to ensure the work is done through a PPP rather than the public sector and to take the only opportunity to win the contract.

Private companies insist that many aspects of PPPs are kept secret, including the contracts themselves. For example, the contract for the water services PPP in Berlin was kept secret until a referendum forced its disclosure.²⁶ In the UK: “Transparency on the full costs and

benefits of PFI projects to both the public and private sectors has been obscured by departments and investors hiding behind commercial confidentiality”.²⁷

In the water sector, courts in France convicted executives and public officials for bribes paid by Suez and Veolia subsidiaries in the cities of Grenoble and Angouleme and the island of Reunion. A 1997 report by the Cour des Comptes, France’s national audit body, said that the system of ‘delegate management’ on which Suez and Veolia build their national dominance was systematically flawed: “The lack of supervision and control of delegated public services, aggravated by the lack of transparency of this form of management led to abuses.”

In Denmark, the mayor of the municipality of Farum, a small town, was committed to radical use of private contractors and PPPs. This included setting up three construction projects on a PPP basis, including a sport stadium and marina, negotiated with the same financial group. The deals were opposed by both citizens groups and business groups. The mayor was found to have issued the contracts illegally, without proper competition, to have taken out an illegal loan and to have used council money to subsidise his football team. Local citizens have had to pay an extra 3.2% local income tax to rectify the municipal finances.

6. Any competitive tendering associated with PPPs does not guarantee savings

PPP tendering procedures take longer and cost more than normal procurement, and so create additional transaction costs for both governments and companies. The complexity of PPPs means that there are very high legal and accountancy expenses involved for both government and companies, with tendering periods lasting an average of 34 months.²⁸ A study by EIB researchers of projects across Europe found that the procurement costs averaged over 10% of the total value of each PPP contract.²⁹ The procurement costs for the Metronet PFI in the UK represented only 2.8% of the project value – but the project itself was so costly, these procurement costs amounted to £455 million. The *Financial Times* estimates that on all PFI deals in the UK: “Consultants and lawyers have earned at least £2.8 billion and probably well over £4 billion advising on the deals”.³⁰

The complexity leads to the use of negotiated or ‘competitive dialogue’ procedures and the cost of bidding means that few companies can afford to bid for PPPs. As a result, there is less competition: in the UK, a recent parliamentary report observed that: “The nature of PFI means that competition is likely to be less intense compared to other forms of procurement. We believe the barriers to entry to be too high, resulting in an uncompetitive market. The long, complex and costly procurement process limits the appetite for consortia to bid for projects and also means that only companies who can afford to lose millions of pounds in failed bids can be involved.”

7. PPPs do not ensure better design innovations

Experience in the UK suggests that PPPs may not generate better designs than normal procurement: “in the area of design innovation and building quality we have seen some evidence to suggest that PFI performs less well than traditionally procured buildings. The fact that consortia are formed to bid for projects also limits choice and competition. For example an architects’ firm may have the best design or there may be one contractor that has produced the best proposal, but unless these designs and proposals are part of the chosen consortium’s bid they will not be used.”³¹

The Dublin Regional Waste Water Scheme in Ireland, opened in 2003, shows that the private sector will not necessarily deliver better design innovations in waste management. There have been consistent smells and odours affecting local residents due to inadequate design and equipment failure caused by the private sector operator Celtic Anlian Water (CAW). Dublin City Council has paid €35.6 million to CAW to try and fix the problems.³²

Another example of a waste management project, which has not maintained high standards of design, is the Kirklees Metropolitan Solid Waste project, UK, a PPP between Kirklees Council and Waste Services Ltd (Suez Environment and SITA). The movement of hazardous waste, diverted from landfill, is creating environmental and health concerns because the infant mortality rate in North Kirklees is one of the worst in the country.³³

8. The private sector is not necessarily more efficient at running services

PPPs are often justified by efficiency gains brought by the private sector: “The key basic rationale is greater private sector efficiency.”³⁴ However, as a recent report from the PSIRU clearly shows there is no systematic difference in efficiency.³⁵ As summarised by the IMF: “Much of the case for PPPs rests on the relative efficiency of the private sector. While there is an extensive literature on this subject, the theory is ambiguous and the empirical evidence is mixed.”³⁶ The UK evidence confirms this with a parliamentary committee report concluding that: “The price of finance is significantly higher with a PFI. The financial cost of repaying the capital investment of PFI investors is therefore considerably greater than the equivalent repayment of direct government investment. We have not seen evidence to suggest that this inefficient method of financing has been offset by the perceived benefits of PFI from increased risk transfer. On the contrary there is evidence of the opposite.”³⁷

The case of Prescom in Targoviste, Romania, shows that the private sector is not necessarily more efficient than the public sector. Prescom, a private waste management contractor provides services to about 80% of Targoviste’s population and five neighbouring communes. The annual revenue is €20m and profit margin is 20%. Salubrita, a state run company has lower charges, reinvests its profits, has a positive cash flow and is self-financed.³⁸

9. The private sector cannot raise money more cheaply than governments

Governments can nearly always raise capital at a lower cost than the private sector. The OECD advises that “the cost of capital of the private partner is usually higher than that of government”, and the IMF has stated that “when PPPs result in private borrowing being substituted for government borrowing, financing costs will in most cases rise”.³⁹ In countries in extreme crisis, the private sector cannot raise money more cheaply through PPPs than governments, because the income of the PPPs depends on payments by the government itself.

The difference is large. The representative of the UK private companies involved in PPPs estimates that the average extra cost of private sector capital over conventional borrowing has been 2.2 per cent a year. The *Financial Times* calculated that this means that the UK taxpayer: “is paying well over £20 billion in extra borrowing costs – the equivalent of more than 40 sizeable new hospitals – for the 700 projects that successive governments have acquired under the private finance initiative.”⁴⁰

The crisis has made the problem worse, for example in the UK: “the difference between direct government funding and the cost of this finance has increased significantly since the financial crisis. The substantial increase in private finance costs means that the PFI financing method is now extremely inefficient. Recent data suggests that the weighted average cost of capital of a PFI is double that of government gilts.”⁴¹

10. PPPs distort public policy priorities and load austerity policies onto other services

PPPs have to be commercially viable or private companies will not take part in them. This distorts the policy decisions made because some projects don't get selected because they are not commercially viable and others are selected because they appear to be commercially viable. Private companies will take out elements of a service which may affect their potential profits.

For example, in Italy, the priorities of PPPs in the health care sector distorted basic public health needs. Italian health care trusts ...neither drew up any calculation for weighting their future costs and revenues related to the project, nor did they consider the social consequences for the community. They merely followed the legal requirements and prepared a financial plan from the private partner perspective.”⁴² It might have been expected that the public authorities would have made an assessment of the public benefit but methodologies for PPPs were structured from a private sector perspective.⁴³

PPPs can weaken the public sector, not just through the scale of repayments over time, but in conjunction with marketization measures, which are imposed on the public sector. In the UK, over the past 20 years, the National Health Service (NHS) has introduced a number of new accounting and pricing systems.^{44 45}

The Queen Elizabeth Hospital (QEH), Greenwich, UK was the first PFI hospital to open in 2001 and the first hospital to be placed “in administration” in 2012, since the NHS was founded in 1948. The QEH recorded a deficit from 2002-03 and the impact of the accounting changes was that the deficit increased almost every year until 2012. An initial reaction, by the Department of Health, to the continued deficits was to merge the Queen Elizabeth Hospital with a nearby hospital, which was also a PFI hospital. The result of merging two PFI hospitals, both struggling with high interest payments and the new pricing system, was that the deficits of the merged hospital increased, resulting in a position of ‘unsustainability’.⁴⁶

11. PPPs are not necessary to solve the problems of countries in crisis

There is no evidence that countries making more use of PPPs are less likely to have fiscal problems. According to the EIB, the five countries which have made the greatest use of PPPs in recent years are Greece, Ireland, Portugal, Spain and the UK.⁴⁷

In the case of Portugal, the IMF/EU package does mention PPPs, but as a major part of the problem, not the solution. The letter of intent requires Portugal to promise: “We will undertake a comprehensive review of PPPs and concessions to reduce the government’s financial exposure. The PPPs have exposed the government to significant financial obligations, and exposed weaknesses in its capacity to effectively manage these arrangements” and to set up a review which “will assess the scope to renegotiate any PPP or concession contracts to reduce financial obligations”: meanwhile Portugal must “suspend the implementation of all new PPPs and large infrastructure projects”.

The Beiras Litoral and Alta Shadow Toll Road in Portugal shows that competitive tendering does not guarantee savings because the tender process was delayed and had to be repeated. There were no public sector comparators. The government had to cover the cost of delays and the costs of implementing an environmental impact assessment (EIA). As a result of the EIA, projects were forced to adopt the higher toll at a high rate.⁴⁸

The entire framework and approach to PPPs has to be reconsidered: “The legal and institutional framework for assessing and entering into PPP or concession agreements as well as monitoring its execution will also be reviewed and strengthened under the supervision of the Ministry of Finance and in consultation with EC and IMF staff by end-2012. We will not enter into any new PPPs or concessions at the central or local government levels until at least the completion of these reviews and legal and institutional reforms.”⁴⁹ In its first review of the package, the IMF noted that one of Portugal’s PPPs has now failed, and urged Portugal to stop regional and local governments from creating PPPs.⁵⁰

Rather than making more use of PPPs, public authorities are avoiding further PPPs and even renationalising existing ones: “Organisations which have the option of other funding routes have increasingly opted against using PFI and have even brought PFIs back in-house. Transport for London’s (TfL) cost of borrowing is higher than government’s, and yet it still considers this is overall better value for money than PFI.”⁵¹

The UK parliamentary Treasury select committee has strongly recommended that the UK government adopt this policy, including taking over the financing of existing PPPs, with large *reduction* in costs: “The Treasury will need to consider using more direct government borrowing to fund new investment. The most straightforward way of dealing with current PFI contracts is for the government to buy up the debt (and possibly also the equity) once the construction stage is over. This would result in an increase in the headline level of government debt but it would not increase the structural deficit. It would become more affordable to service the visible government debt rather than the hidden PFI debt. Every one percentage point reduction in the interest rate paid on the estimated £40 billion of PFI debt would realise annual savings of £400 million.”⁵²

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- ⁵¹ UK Treasury Select Committee 17th Report – *Private Finance Initiative*, HC 1146, August 2011, www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1146/114602.htm
- ⁵² UK Treasury Select Committee 17th Report – *Private Finance Initiative*, HC 1146, August 2011, www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1146/114602.htm

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