

Financing Public Infrastructure

*Darrin Grimsey and Mervyn K Lewis, **Public Private Partnerships: The Worldwide Revolution in Infrastructure Provision and Private Finance**, Edward Elgar, Cheltenham, 2004*

Reviewed by Christopher Findlay

The South Australian government, according to the local newspaper, *The Times*, on 17 February this year, has chosen a preferred bidder to construct a new police station and court complex in Port Lincoln. The private sector provider would design, build and maintain the facility, which it would then lease to the government for 25 years. The winning consortium included financiers and debt providers, builders, facilities managers, consulting engineers and architects.

This model of provision is becoming more and more popular in Australia. State governments have established offices that manage these arrangements, with perhaps the best known example being Partnerships Victoria (www.partnerships.vic.gov.au). The Commonwealth more recently has shown greater interest in the model of service provision. In a speech to a Pacific Economic Cooperation Council forum in Sydney last December, The Hon. Dr Sharman Stone MP, Parliamentary Secretary to the Minister for Finance and Administration, explained the Commonwealth's approach to Public Private Partnerships (PPPs), and identified a number of new proposals for partnerships. (See <http://www.finance.gov.au/scripts/Media.asp?Table=PSEC&Id=14>).

However, the value of partnership models like that in the Port Lincoln police station has been hotly debated in Australia. Correspondents of the *Australian Financial Review* have insisted that these PPPs create 'muddles' and 'conflicts'. Vivek Chaudhri and Paul Kerin (2005), writing on the opinion page in the same newspaper in January this year, guess that of the 'large infrastructure projects under way or proposed in Australia, less than 5 per cent (by value) would be best conducted through PPPs'. Around the world, there are plenty of examples of bad PPPs — the case of the Mexican toll roads being an outstanding example (Ruster, 1997), in which the government ended up bailing out the private sector.

The collaboration in this book by Grimsey (a partner in Pricewaterhouse Coopers) and Lewis (Banking and Finance Professor at the University of South Australia) is timely. Their framework provides answers to many of the questions people are asking about PPPs: when are they value for money? is the public interest served by a PPP? don't PPPs simply amount to a 'free kick' to the private sector to make profits out of traditional government business? The book also highlights the point that getting PPPs right is not easy, and doing so also demands government capacity in managing bidding processes and writing contracts, as well as in economic regulation.

As Grimsey and Lewis explain, PPPs involve the sharing of risks between the private and public sectors to deliver an agreed outcome or service. The private participants can include one or more businesses, as in the Port Lincoln example. The partnerships are designed to achieve more efficient procurement of goods and services than by governments acting alone.

In a traditional approach to procurement, governments would design a project, such as a police station/court house complex, buy all the components separately and supervise construction of the facility, and then manage its operation. From the PPP perspective the question is whether some or all of these activities might be bundled together and provided by the private sector.

Hart (2003), cited by Grimsey and Lewis, along with a number of other papers on this framework question, examines a case in which the government can either contract out to the private sector both the building and operation of an infrastructure facility, or can contract the building and operations separately. The latter Hart refers to as 'conventional provision', and the former as having the core features of a public private partnership (PPP). He argues that the choice depends on the relative importance of different types of error. Unbundling provides an incentive to build at lowest possible cost, which includes too little investment in aspects of the facility that might later lower its operating cost. Bundling leads to investments that take these spillovers between structures and subsequent costs of operation into account. Bundling leads to other actions that diminish or 'shade' the quality, but also lower the cost of operation, of the services. The choice therefore depends on the relative importance of the spillover effect compared to the quality shading effect.

Hart concludes that unbundling is preferred if the quality of the facility can be well specified, but the quality of the service cannot be: this approach therefore avoids the problem of quality shading that can occur in bundling. A bundled approach is preferred if the service can be well specified, whereas the quality of the facility cannot be (that is, where the spillover effect between facility characteristics and operations is important, and which, in the unbundled approach, the builder would not take into account).

The extreme form of a PPP involves the private sector financing, building, owning and operating an asset and eventually transferring it back to the public sector. As Chaudhri and Kerin explain, the value of this model depends on whether the private sector has a genuine competitive advantage, whether transferring risk to the private party improves performance, and whether bundling pays. They are also concerned about whether efficient bidding and contracting can be arranged, and their concern about these four points leads to their assessment of the limited scope to use the PPP model, at least in that extreme form. A PPP in this form is more likely to be appropriate in an innovative project using a design in which construction and operating risk are connected. Quiggin (2004) also questions the likely frequency of this circumstance, and whether a 'financier-led' approach to procurement provides any advantage compared to the government arranging the contracts itself. He describes the adoption of PPP programs by state governments as a 'triumph of hope over experience' (p. 60).

Grimsey and Lewis point out, however, that there is a variety of models of partnerships, and that taking a wider view of the options is useful. Full privatisation is at one extreme of the possible models of service provision. The simplest form of private participation is a service contract. In between there is a wide variety of options, including Design Build Operate and Manage, and Build Lease Transfer Maintain.

The choice of model depends on the capacity to negotiate and implement the relevant contract, and also on the gains from redistributing risk. Grimsey and Lewis have a chapter on the categories of risks likely to be observed (design, construction, operations, revenue, financial, force majeure, regulatory and political, environmental) and how they might be allocated. The basic principle is to allocate risk to those who can manage it at least cost. Details of how various risks are treated in different PPP structures and contracts, and examples of the linkages between them that are relevant to the case for bundling of activities, are provided in the book.

To weigh the gains from a redistribution of risk against other factors, Grimsey and Lewis explain how to apply the Public Service Comparator. In this methodology the cost of the services payments (plus that of any risk retained by government) under the PPP model is compared with public provision. A problem in evaluating a PPP proposal is determining the cost of capital. Grimsey and Lewis tackle the view that PPPs can never provide value for money because governments can borrow more cheaply. They point out that there is little risk in government debt, since governments can raise taxes to meet their obligations. But that means taxpayers are bearing a risk, and the cost of that burden should be taken into account in any cost-benefit analysis.

Another common talking point on PPPs is how to make sure the wider public interest is being served. The wider application of the model to prisons, courts and schools intensifies interest in this issue. Government procurement and its procedures would be subject to parliamentary scrutiny. This does not apply to PPPs, and market discipline on their operations is also usually absent. The solution, as Grimsey and Lewis explain, lies in the bidding and contracting process, for which they lay out the components of a public interest test. This is especially important, since those stages have to involve extensive discussion between the government and private sector over the allocation of risks.

Grimsey and Lewis examine the criticism that PPPs involve 'back door financing', since the financing of the projects is shifted off the balance sheet of the government. The government continues to assume liabilities linked to the project, and the authors review the debate on how to account for those risks. The UK experience is particularly relevant.

The framework elaborated here applies to all forms of procurement, but a major interest in the book is infrastructure projects — also currently topical in Australia, with claims of lack of capacity in that sector by the business community, and with a government enquiry underway. The framework is relevant, since in large infrastructure projects the government is procuring services in behalf of households. The main challenge is also the appropriate allocation of

risks, and the ways of dealing with the inevitable incompleteness of contracts, including the role of re-negotiations and of complementary regulatory processes that can be used to reduce the complexity of the contracts. (The contracting perspective is presented by Gomez-Ibanez, 2003, and discussed by Findlay, 2005). According to this perspective, lack of capacity could be due to an inefficient allocation of risks in the initial design of contracts, which impedes private participation, or an ineffective process for dealing with incompleteness in those contracts, including through regulatory errors. The interaction between the regulatory process and the design of PPPs is one topic that Grimsey and Lewis might have taken further.

The authors report a number of useful case studies, particularly from the UK, and have compiled a companion volume (Grimsey and Lewis, 2005) of 36 papers on PPPs. (The World Bank publication *Private Sector* is another good source available online at: <http://rru.worldbank.org/PublicPolicyJournal/>). The present volume also contains a chapter on governance arrangements in PPPs and another on the operation in PPPs in emerging markets, including some case examples. Currently, a significant gap in this field is the lack of an extensive set of Australian case studies. Filling that gap would be useful.

References

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