PUBLIC – PRIVATE PARTNERSHIPS A COMPONENT OF PUBLIC PROCUREMENT SYSTEM

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ABSTRACT
While many in the community may remain suspicious of private sector involvement in public infrastructure, the truth is that old concept 'command and control' in the public sector are going to smashes and are being replaced by new interrelationships between government and private sector entities.

The purpose of this article is to illustrate that Public Private Partnerships (PPPs) are a way of introducing very different incentives into the procurement process. The theory of PPPs suggests that incentives to productive efficiencies can be introduced into infrastructure procurement by vesting control rights with the private sector, bundling into one contract the design, construction, operation and maintenance of the facility, and by transferring the risk of cost and time overruns to the private partner.

KEYWORDS: Public – Private Partnerships, Value for Money, Traditional Procurement, Ownership rights, Bundling, Risk transfer

First of all, let’s introduce the concept of public private partnership and to highlight the difference between this new concept and traditional public procurement.

The Public Procurement Directives define works concession contracts, services concession contracts and public contracts, so:
• public works concession is a contract of the same type as a public works contract except for the fact that the consideration for the works to be carried out consists either solely in the right to exploit the work or in this right together with payment.
• service concession is a contract of the same type as a public service contract except for the fact that the consideration for the provision of services consists either solely in the right to exploit the service or in this right together with payment.
• public contracts are contracts for pecuniary interest concluded in writing between one or more economic operators and one or more contracting authorities and having as their object, in our case, the execution of works or the provision of services within the meaning of this Directive.
In traditional public procurement procedures, private companies have long been involved in building roads, hospitals, schools and public buildings, and in providing management and maintenance services. What differs with a PPP is that these separate arrangements are combined (bundled) into one contract and a private sector organization charged with providing, not a building, but a flow of infrastructure services over time.

In other words, PPP are defined as infrastructure projects procured under DBFO/M-type contracts that bundle Design, Build, Finance and Operation/Maintenance. When users pay directly for the service, such contracts are also referred to as concessions.

For instance, under traditional procurement, the public sector authority may enter first into a Design-Build (DB) contract, engaging a private sector organization to design and build a facility in accordance with requirements determined by the government. After the facility is completed and paid for, the government assumes responsibility for operating and maintaining the facility. It may then use a service or management contract to outsource all or part of operations and maintenance.

With a PPP, these separate contracts would be combined. For example, with a Design-Build-Finance-Operate-Maintain (DBFOM) contract the private sector organization, usually a Special Purpose Vehicle (SPV) company created for the project, designs, builds, finances, operates and maintains a new or refurbished facility under a long-term lease (20, 30 years or more). At the end of the concession period, the private party transfers the facility to the public sector.

Thus, the tricky question arises why a government authority would engage in a DBFOM transaction. Why would it tie its hands in this way for 30 years, let’s say, rather than opt for the flexibility of separate contracts? The question is heightened when it is appreciated that the SPV will itself enter into a separate contract for design or design-build with a construction company, a financing arrangement with senior lenders, and an operations and maintenance contract with a facilities management company. Why is it presumed that the SPV company can contract more cheaply or effectively with the other parties than can the government body?

One answer is that the arrangement does appear to work, at least in many cases. The difference lies in different levels of responsibility and accountability. In conventional procurement, when the government acquires the infrastructure, designs the facility and delivers the service, it does so in an environment largely removed from the economic signals to which private entities are exposed. The government’s cost of fund raising, whether by debt or taxation or charges, bears no relationship to the project’s risks or its likely success or failure. A wide variety of performance outcomes can be swept under the administrative mat, and the principals involved are often insulated from the consequences of their actions and decisions. Infrastructure decisions necessarily have consequences and generate obligations that last for generations. Yet the politicians and senior officials making
them bear little personal responsibility for the consequences, and thus face few incentives to modify or change their behaviour.

Compared to traditional procurement, a well structured PPP can introduce clear lines of accountability, transparency of outcomes and performance, clarity as to the roles and responsibilities of the contracting parties, an assessment of the project risks, competition for the delivery of services, and the motivation to succeed.

Under a fixed price contract, the government separately engages a private organization to develop the design component of the documentation used to tender the construction contract. The successful contractor has to deliver the works at the fixed price tendered provided there are no variations to the design.

Under a PPP, the government becomes a purchaser of asset-based infrastructure services that are paid for against performance. There is potential for the PPP to provide value for money where:

- it is possible to clearly define required outputs to allow a payment mechanism to be structured that aligns with project objectives;
- the project has scope for innovation;
- there are opportunities for the transfer of certain risks (for example, design, cost and time overruns) to the private sector that it can better manage;
- whole-of-life costing can reduce operating costs by building in features that a focus on immediate construction costs would ignore;
- reliance on user fees for revenue can create an incentive for private operators to provide good customer service;
- proper maintenance can lengthen the life of the facility and increase residual asset value.

The difference between the two types of public procurement, the traditional one and in partnership with the private sector, can be structured as measured by the ownership rights, bundling and risk transfer.

Many experts, who mention Frederic Blanc-Brude, Hugh Goldsmith and Timo Valila, affirm that the ownership rights are a good starting point for considering the economic consequences of PPPs. In case of PPP, the public sector transfers land, property or facilities controlled by it to the private sector which is given ownership or control rights for the term of the concession.

This assignment of the residual control rights provides an incentive for the private sector entity to undertake relation specific cost-saving investment that increases productive efficiency.

In the absence of this assignment the private organization would not be sure that the investment would pay off and there would be under-investment in the new technology. Turning over the control rights for the infrastructure can minimize this situation.

A very important feature of the PPP, such as Oliver Hart says, is bundling, whereby the infrastructure asset's construction and operation is combined in a single contractual framework. Hart developed case studies in terms of transactions
costs, with the choice between bundled or unbundled structures governed by whether it is easier to write contracts on service provision than on the quality of the building.

The PPP is better if the quality of the service can be well specified in the original contract, whereas the quality of the building can’t; in case of unbundling, the situation is reversed.

Bundling of construction and operations offers an impulse to make larger upfront outlays in the construction phase in order to achieve lower life-cycle maintenance costs.

The transfer of risk to the private sector can also make a PPP more cost efficient than traditional procurement. In several works, Grout shows the importance of information costs and the incentive structure created by the PPP service payment mechanism.

Determining responsibility for cost overruns is a serious source of conflict when there are design changes or unexpected developments. Writing the contract in terms of the flow of services from the infrastructure facility rather than the process of construction can change the incentive system.

These incentives are blunted under traditional procurement if the public sector carries most construction cost and delay risk. An effective transfer of risk from the public to the private sector can lead to lower risk, since it is the acceptance of risk that gives the private organization the motivation to price and produce efficiently. Private finance (debt and equity) is central to this process. In cases where the privately-provided finance at risk acts as an accelerator for the injection of risk management techniques into the project in a way that is not possible under government financing.

Some controversial issues related to PPP are discussed by many experts, considering the fact that the field is in constant transformation.

Regarding the cost of finance, one of the constant objections to PPPs is that the private sector’s cost of funds is more expensive than the government’s cost of debt used to fund a traditional procurement. This is true, but only up to a point, for the lower government borrowing cost argument does not stand up. What is important is the true risk of the project.

Payments under PPP schemes involve significant fixed payments to cover interest charges and capital repayment. These debt repayment charges introduced into the finances of public sector authorities are said to limit the later flexibility of these bodies, by mortgaging the future in return for immediate gains since payments are transferred to the future. The counter-argument is that construction can be brought forward with the cost of infrastructure investment spread over the life of the asset, much as homebuyers do when they take out a mortgage or use leasing and hire purchase facilities.

On the other hand, the contractually binding commitment over the project life for the services included in the project can be criticized for reducing the autonomy of public sector management in relation to discretionary spending.
Concurrently, however, it removes the ability to divert funding from needed maintenance work.

Critics often suggest that there is no substantive risk transfer under a PPP. However, this is truer of the traditional approach with design and construct. As the builder is not responsible for how the buildings function, there is an implicit temptation to build (or at least tender) cheaply. There is also not an incentive to take into account the whole of life trade-offs that might exist.

Under a PPP approach the contractor is forced to think longer term and also can’t just leave having completed the construction. The contractor has ongoing, long-term responsibility for the facility’s performance, which is reflected in performance-based monthly payments. Even if the contractor is unable to fulfill its obligations, and terminates the partnership, it can’t take the facility away and, in most cases, the assets revert to the public sector.

It takes a long time to agree the risk transfers, payments and terms that are acceptable to both parties - imposing considerable legal and due diligence costs on both the contractors and public sector side.

PPPs are generally not recommended for small individual projects, although combining a number of small projects helps to spread procurement costs across several projects.

Overall procurement costs could be reduced if it were accepted that PPPs had been sufficiently tested in certain applications, thereby dispensing with the (not inconsiderable) cost of preparing the PSC. A competitive bidding process would then ensure value for money.

Adding a number of projects together is one of a number of developments that have occurred in recent years to lower procurement costs of traditional PPPs, introduce flexibility and allow for uncertainties and technological change. Because often combine some elements of PPPs and traditional procurement, in specific literature may be found the hybrid term.

PPPs are a way of introducing very different incentives into the procurement process. The theory of PPPs suggests that incentives to productive efficiencies can be introduced into infrastructure procurement by vesting control rights with the private sector, bundling into one contract the design, construction, operation and maintenance of the facility, and by transferring the risk of cost and time overruns to the private partner. At a practical level, the disciplines injected by the participation of private capital that is genuinely ‘at risk’ and that is not artificially low and separated from project risk. Evidence has been presented that the private sector does appear to respond to these signals.

However, PPPs are too complex, and costly, for many small projects. In some cases, they may be beyond the capacity of the public sector agency to implement and manage. For other projects the tight specification of the outputs required may be difficult to detail for an extended period. Recognition of these problems has seen the development of new hybrid PPPs, embodying different degrees of partnership, with the aim of reducing procurement costs and generating flexibility for evolving infrastructure needs, while retaining clear lines of
responsibility and the proper motivation for the parties involved. The consequence of this blurring of traditional procurement and PPP structures is a continuum of delivery models available to accommodate different risk preferences and infrastructure service needs.

References


