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Managing Public – Private Partnership Market in the Times of Economic crisis

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Abstract: *The article focuses on the issues and problems caused by the economic crisis of 2008 for public-private partnership (PPP). The challenges faced are presented from the point of view of a public entity, a private partner and a financial institution, as well as the relationships between these parties and the influence of economic issues on these relations. The most crucial of these challenges seems to be: the pressure on public finance and growing difficulties in financing the public infrastructural investments, the rise of the economic risk of investments and the necessity of sufficient and appropriate transfer and management of risk, and finally – the lack of interest of financial institutions to finance long-term liabilities. The aim of the author is to provide a precise description and diagnosis of the issues mentioned above, which might improve the strategic management of PPP market*

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as well as management of projects. The article is based on experience, documents and working papers concerning the countries and markets of the European Union but the presented conclusions should be of more universal nature.

Introduction

The economic and financial crisis which started in 2008 significantly changed the way of considering the role of public-private partnership (PPP). In the past, the number of PPP projects fell rapidly during dotcom bubble burst, and then peaked again in years 2006/2007. It seems that development of PPP is a reflection of an economic cycle. But, according to some experts, the present crisis might be exceptional (e.g., taking into account the length of economic stagnation), even worse than the crisis in the thirties of the 20th century. Moreover, globalization and liberalization of the markets causes the reorientation the role of the state including public services and investments. In times of crisis the state has to limit its activity; it may deliver public services only to a certain extent. Therefore, in many countries anti-crisis actions include stimulation of the economy by increasing the role of private capital in financing public investments and services including public-private partnership model. However, managing public-private partnership market in the times of economic crisis is not easy. Public-private partnership combines all the problems that the crisis causes in the private sector, the public sector and in the financial institutions sector. While observing PPP one might find the essence of the economic crisis because the interests and specificities of all these three players meet in one place.

The idea of writing this article was borne from the necessity of identification and description the challenges which face the management of public-private partnership projects in the recession or stagnation times. These challenges differ significantly while considering the view of the public sector, the private sector or the financing institutions – my goal would be to present these differences. The presentation of the mutual relations between these challenges and the influence of economic factors on parties involved in PPP projects would be equally important. The sound and precise diagnosis of these phenomenon might help to work out the solutions expected either in strategic management of PPP by political decision makers, or in the management of the projects by public and private sector managers. Due to the common character of PPP model and global character of economic crisis the presented conclusions should be of more universal nature.

Methodology

The considerations will focus on problems of the European Union states and markets. The analysis are based mostly on the official documents, i.e. legal acts, state policy statements, guidelines and scientific elaborations (books, articles). Materials and presentations from the science and professional conferences and workshops were also used in the works on this article.

Nature of PPP

Contemporary public private-partnership has grown up on the ground of the public sector seeking new methods of financing public tasks in times of shortage of investment funds in government and self-government budgets, as well as seeking new ways of implementation of these tasks, allowing more effective usage of invested expenditures or getting higher standard of services. Public-private partnership enables the division of capital costs for the whole period of the project, rather than direct transfer from public budget. In theory, public-private partnership may ease the transfer of know-how, the management skills and technical knowledge from the private to the public sector, so that the abovementioned knowledge and skills serve to fulfill the public tasks and to provide the public services (Bejm et al., 2010, p. 11).

In the countries with a wide PPP experience the main reason for choosing a PPP was its surplus value. The value added includes: proper risk allocation between private and public sector, the use of competitive performance-oriented management skills, the availability of the innovative solutions adjusted to end user expectations, ensuring flexible conditions in PPP contracts and appropriate motivation for public sector (Brzozowska, 2010, p. 31).

There is no single, internationally-accepted definition of the PPP – it covers the wide range of long term, risk-sharing cooperation between the government and private entity for provision of the public service. Under PPP agreement the parties share risks of the project. The level of risk in PPP projects varies from the standard procurement projects. A risk is defined as any factor, event or influence that threatens the successful completion of a project in terms of time, cost or quality. A key principle of PPPs is that risk should be allocated to the party best able to manage it. The effective allocation of risk has a direct financial impact on the project, as it will result in lower overall project costs and will therefore provide enhanced

value for money if compared to traditional procurement methods (European Commission, 2003, p. 50).

There are three main kinds of risk that arise in infrastructural projects:

- construction risk, mainly for physical infrastructure such as roads or railways: if the product is not delivered on time, runs up extra costs or has technical defects. The risk is borne by the partner who pays for such unforeseen cases – usually the private partner.
- availability risk, mainly for services such as running prisons, hospitals or schools; if the private company cannot provide the service promised, or at the level promised. For example, it does not meet safety or other relevant quality standards. If the public sector is contractually allowed to withhold payments then the risk is borne by the private sector.
- demand risk, in cases where there are fewer users of the service or infrastructure than expected, for example on toll-roads, bridges or tunnels. If the public sector has agreed to pay a minimum fee irrespective of the demand, it is assumed to bear the demand risk (CEE Bankwatch Network, 2008, p. 9).

An important issue is a form and source of private partner remuneration, which is the key factor in addressing the risk. Basically, there are two models of the PPP from that point of view- in the first one, called the concession model, the remuneration comes directly from the payments from end users. Most of all, these revenues are charges for the services provided e.g., from drivers of toll motorways. This model is called a concession – the economic risk (demand risk for a service) bears the private partner.

In the second model, called PPP *sensu stricto*, the remuneration of private partner comes from periodic fees from public entity. In the contract, the amount of payment is strictly specified between parties and generally does not depend on the actual demand of end users, but on assuring by private partner an appropriate standard and availability of the object of partnership.

In this model the public partner is a purchaser of provided services (e.g., constructed and operated by the private partner school or hospital) and the economic risk bears a public sector (if there is any economic risk in this case- this model is used in non-commercial projects). Obviously, there are many other variants between the above models but the practice shows that in any case one of the approaches is dominant.

The form of remuneration of a private partner (concession model or so-called „availability fee” model) is essential – in most countries’ legal systems it decides on selection of private partner, on accounting approach to assets and cash flows under completing a project, and especially about other elements of relationship (division of remaining risks) between partners.

The choice of financial model of private partner remuneration must be suitable to the character (commercial capability) of project, as well as to the conditions of obtaining finance (the role of financial institutions).

There are different types of public-private partnerships:

- Operation and Maintenance – OM – A public partner contracts with a private partner to operate and maintain a publicly owned facility. Under the private operation and maintenance option, the public partner retains ownership and overall management of the public facility or system. The private partner improves service quality and its efficiency, finances the whole maintenance and collects fees. OM contract is used in a broad range of municipal services including water and wastewater, solid waste removal, sewage system;
- Design & Build – DB – a public contractor and a private contractor sign a contract where the private partner provides the design and construction of a facility. The aim of the facility is to provide public services. Once the facility has been built, the local government takes ownership and is responsible for the operation of the facility. DB is often used in most public infrastructure and building projects, e.g. swimming pools, roads etc.;
- Design & Build & Operation – DBO– under this model a contract is awarded for the design, construction and operation by a private partner. This model might be used in all cases where the title to the facility remains with the public sector and if the public authority is interested in entrepreneur's experience in construction and operation of a facility;
- Wrap Around Addition – under that scheme a private partner finances and constructs an addition to an existing public facility. The private partner may then operate the addition to the facility for a specified period of time or until the partner recovers the investment plus a reasonable return on the investment. The advantage of this model is that private partner has to provide capital funding for the upgrade, so the financial risk rests with the private partner;
- Lease & Purchase – under this model a private partner designs, builds and finances a new facility, which is then leased to a public agency. The public agency makes scheduled lease payments to the private party. The public agency acquires equity in the facility with each payment. At the end of the lease term, the public agency owns the facility;
- Temporary Privatization – under this model the ownership of an existing facility is transferred to a private partner, who improves and/or expands the facility. Afterwards, the private partner operates a facility, collects

charges for the time specified in the contract. At the end of the contract, the ownership is transferred to the public sector;

- Lease & Develop & Operate or Buy & Develop & Operate – under these partnership agreements, the private partner leases or buys an existing facility from the local government, invests their own capital to renovate, modernize, and/or expand the facility; and then operates the facility under a contract with the local government. The public partner collects payments from leasing or sale. Moreover, the facility might be difficult to value for sale because sometimes doubt might occur whether a facility financed from a subsidy can be sold;
- Build & Operate & Transfer – BOT or Modernize & Operate/Own & Transfer – MOT – or Build & Lease/Rent & Transfer – BL/RT – under this model a private partner constructs, finances and operates a facility. The private partner also collects payments stated in the contract. Once completed, the private partner transfers the ownership of a facility to a public partner;
- Build & Transfer & Operate – BTO – under this model a private partner constructs and finances a new facility. At the end of the construction period the private partner transfers the ownership to the public partner and franchises this facility. The franchise must be sufficient to enable the private partner to realize a reasonable return on their investment through user charges;
- Design & Build & Finance & Operate – DBFO or Design & Create & Manage & Finance – DCMF or Build & Own & Operate – BOO, also Renew & Own & Operate – ROO – that model indicates overall privatization of public services. The private partner designs, builds (renews), finance, manages, owns and operates private entity, sets fees for provided services and collects charges. The public partner makes rules and regulations for the operations and to control pricing (Płonka-Bielenin, Moll, 2012, pp. 16-18).

Crisis and the financial institutions in the PPP context

PPP can be described as a long term contract with a long capital return. A typical project covers an investment phase (or construction phase), which lasts 2-5 years, and an operational phase lasting 20-30 years. The investment phase demands significant financial funds for the provision of which the private partner is responsible (from the point of view of the public entity, private partner's ability to bear the investment costs is a main reason of application the PPP model). These funds usually come from loans provided

by financial institutions. The repayment of a loan takes place during an operational phase from the private partner remuneration in the form of “availability fees” from the public partner or from user’s fees. The features of such a credit resemble the features of mortgage loan for home buyer or builder– the equity contribution (about 20%) and the credit period (20-30 years) are similar. However, the amount of credit is substantially different – the property value is several hundreds of thousands of euro, the PPP project value reaches a few hundred million euro. In many countries, granting a credit in such difficult times is not a tempting perspective for commercial banks, especially when the collateral are the future revenues coming from charges of service users. The best example are motorway tolls for drivers. The level of these revenues, resulting from the demand for services, is highly uncertain in the perspective of the next decades. Many factors may change: the economy, behavior and preferences of potential users (e.g. increase of alternative means of transport popularity), the construction of competitive roads, rails and air networks. The number of variables which influence the profitability of investment and the economic risk is large.

The risk aversion among banks has caused an increase in credit margins, which effected higher costs of raising capital. Furthermore, due to unsuccessful financial operations, some banks have problems with their liquidity. Nowadays, it is very difficult to obtain funds for long-term projects, the banks demand flexibility from lenders, especially in terms of the right to increase interest rates. Such situation has certainly been going on for some time, as presently there is no signal from the market for banks to return to pre-crisis offers. Today, even those with a strong position are not willing to borrow more than averagely 50-70 million euro (Rytel, 2009, p.14). How little it is can be shown by the cost of construction of 1 kilometer of a motorway – approximately 10 million euro. Today, short-term, consumptive and commercial credits are dominant, they are less hazardous and generate high revenues for banks. If financing by banks is a problem and governments desire the PPP development, they will be forced to start crediting from public sector. They can create national public banks which would help to finance infrastructure. It is a paradox, considering that the aim of PPP is avoidance of public budget in financing infrastructure.

The most important financial institutions in a PPP context are:

- International Finance Corporation (IFC), part of the World Bank Group
- Inter-American Development Bank (IADB),
- Asian Development Bank (ADB),
- European Bank for Reconstruction and Development (EBRD),
- European Investment Bank (EIB).

As International Finance Institutions are independent of an individual country's budget and are used to financing public sector infrastructure, it is natural step for them to deal with PPPs. However, their business is confined to developing countries, and has to be „additional” to lending by commercial banks and other private sector sources, which means that if funding is available on reasonable terms from the latter, the International Financial Institution must step out of the picture. International Financial Institutions are generally required to provide commercial terms, which also ensures that their lending is additional, for there would be no reason to borrow from them if the same terms could be obtained elsewhere (Yescombe, 2008, pp. 436-437). It is also important that International Finance Institutions provides advisory services in this area.

Another solution is minimizing the project economic risk by various kinds of public sector commitments – e.g. credit guarantees or investment profitability guarantee (if private partner gets no profit caused by lower demand for services, the public party covers with subsidies all not earned revenues). It should be taken into consideration that bearing economic risk by public sector implies registration of PPP assets on the central government (or local/regional) balance sheet and public sector liability. That makes the PPP much less attractive.

In the current financial market conditions, the European Union proposes a new financial instrument – EU Project Bonds. The objective of the EU Project Bonds is to secure investment through PPP for infrastructure projects of high strategic European interest. In a nutshell, project bonds are debt instruments issued by PPP project companies and typically bought by institutional investors (e.g. pension funds, insurance companies). They are sometimes tradable on secondary markets. While bond financing plays a significant role in some PPP markets outside of Europe (e.g. Canada), „true project bonds” are still in their infancy in Europe and raise a number of issues, in particular for procuring authorities during the project procurement phase. The public sector has a key role to play in facilitating the use of project bonds in PPPs. (EPEC 2012, p.2).

Crisis and the supply side (public partner)

The supply side (public partner) comprises: government, local self-government unit, regional investment funds. These entities bring into an agreement:

- financial capital, mostly cash,

- assets, especially real estates; municipalities often own lands and buildings, attractive for investors. Also the entities connected with community own tasks were transferred to counties and voivodeships,
- state guarantees: it is a very attractive instrument which influences the reduction of loan interest rates,
- payments from the public authority budget for the services provided by a private partner; sometimes it happens that the private investor makes no profit on business (e.g. waste collection) at lower costs, in that case outsourcing and constant payments would be more beneficial for the public party,
- concessions and licenses for different activities; it is an input hard which is to value. It is very attractive for private partner because the public authority has a monopoly on some concessions and licenses (e.g. roads – the state, area development plans- the commune). The involvement of public authority signalizes that obtaining concession or license would be easier, shorter what influences reduction of financial costs (Moszoro, 2010, pp. 46-48).

The crisis has exposed the situation of public finance in many countries. On the one hand, it is postulated that public investments should boost the economic growth, on the other the governments do not have funds for the implementation of that policy. The entrance of a private partner into public projects is often a relief to the public authority because it can sometimes move projects off the government balance sheet. At the present time, PPP is treated as an element of creative accounting and nobody is interested in increasing the project efficiency. However, this is misleading as PPPs do not bring in extra money, but constitute expensive commitments for the public sector for around the next thirty years, which can lead to public service closure or higher charges for the public. Furthermore, the institutions responsible for the public debt are much better at identifying the actual liabilities which PPP projects bring. The Eurostat statistical treatment of PPP determining the impact of PPPs on government debt and deficit requires the stringent rules. All assets established by the PPP transaction should be recorded on government balance sheet with corresponding public sector liability, unless the most of project risk is transferred to the non-governmental partner. But the transfer of the economic risk on the private partner it is not easy. It is important to remember that a private partner expects incentives for taking risks- the level of incentive might be so high that PPP model will be more costly than the traditional procurement.

In such difficult times, the public partner should take more responsibilities and risks in order to make PPP projects attractive. It means that the project would overburden the public finance like in a traditional procure-

ment. Therefore, the main criteria of choosing PPP model should be its efficiency, so called “value for money”. The public partner on the conceptual stage should evaluate if the project is profitable for public finances and end-users, or if it represents its value for money comparing to alternative methods of making an investment. The public partner cannot only think about “here and now” they should analyze the influence of PPP projects on the budget in 10-15 years. That postulate is idealistic, taking into account the fact that big investment projects are connected with political voting cycles, which are of much shorter time horizon.

Crisis and the demand side (private partner)

The private entity which is a party to a public-private partnership are mostly companies, big corporations or consortiums able to manage financial, technological and organizational challenges connected with big investment projects. The private sector, besides cash and fixed assets brings to the project:

- long-term loans; in infrastructural investments – e.g. in energy sector or road construction – 10-15% funds come from contribution from partners, the remaining 85-90% usually from long-term bank loans,
- long-term bonds, as a bond holder; bonds issued by companies are cheaper form of getting capital than obtaining investment loan. Different strategies of issuance might help the public party to gain desired results (e.g. promotion in and outside the region, involvement of local society). The strategies might cover wide range: from bonds convertible on stock, to bonds with option e.g. the priority of acquiring municipal property,
- insurance; protection of multimillion investments inquires participation of specialized institutions: private investor reduces the risk of investment failure,
- know-how, the knowledge and skills of investment management, it is a main advantage of private partner. Although know-how is not a financial input, the experience in: management of private investments, shorter time of construction, operational management accelerating turn-overs, reduction of operational costs, experience in negotiating with banks and investment operators undoubtedly have immediate financial consequences (Moszoro, 2010, pp. 48-49).

A crisis has changed the way of thinking about private partner as a co-financing public tasks. Before the crisis this role was essential, at present much more is expected, especially in case of limitation of public finances. Whereas, providing external financing is very expensive or impossible.

Even the largest companies have problems. A spectacular example of such a crisis is the construction of A1 motorway in Poland between Łódź and Katowice, where the concessionaire would not be able to provide financing, although more than half of funds were guaranteed by European Investment Bank and the investment related to the busiest road, not having alternative routes.

On the other hand, the recession time is often very attractive for private sector to involve in public investments. These investments allow to survive difficult times regarding a decline in orders on the private investment market. The private party more agree to compromise and to hold down the expectations to the level of profit, in order to gain certain and stable source of revenues, which is a public investment contract. So, from that perspective, the public-private partnership seems to be very attractive – and at adequate arrangement with public partner, provides the source of profit not only stable, but also long-term. The entry of private partner in PPP project is a chance for authentic stabilization, gaining the perspective of economic safety, necessary in building a long-term strategy.

It should be emphasized that a prerequisite for effective usage of advantages which PPP projects generate to private partner are solid basis and realistic expectations. The private partner must have a financial and organizational capability to complete and manage investment, which guarantees capital return after longer time and on moderate level. Therefore, PPP is not an instrument of dynamic expansion, but of stabilization and strengthening position.

Conclusions

In the times of economic crisis it is easier to recognize the essence of some issues. It concerns also the public private partnership. The philosophy of this model changes – the point is to find such model of cooperation which could be attractive from public partner view, profitable for private partner, safe for financial institutions and finally appropriate for end user of public services. In the times of recession it is easy to perceive how hard is to find a proper model. It is obvious that this model is not a panacea for investment needs of a state, rather exceptional and complementary solution, it demands particular conditions and carefulness. The key is appropriate selection of projects. It is very important to analyze benefits and disadvantages. It should be determined in which sectors and what types of projects might be made in that model. In order to implement PPP successfully, it is necessary to understand its way of functioning.

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