Chapter 7

Unpacking the dangerous illusion of PPPs

By María José Romero and Mathieu Vervynckt

Public-private partnerships (PPPs) are increasingly being promoted as a way of securing much-needed funds to deliver development projects. Their promoters argue that they are an efficient way to bridge the infrastructure gap and provide services essential to achieving the Sustainable Development Goals, set out in the UN Agenda 2030.

PPPs are a medium- or long-term contractual arrangement between the state, a regional or local authority, and a private sector company, in which the private sector participates in the supply of assets and services traditionally provided by government. Examples include hospitals, schools, prisons, roads, railways, water, sanitation and energy services. As such, they include areas that affect the basic human rights of citizens.

PPPs are presented as an alternative to the traditional way of procuring public infrastructure or delivering social services. In traditional procurement, the state has to finance and pay the costs upfront when a road or a school is built. With PPPs, on the other hand, the costs are spread over a long period of time. This relieves the public treasury and reduces borrowing needs at the outset. However, PPPs may store up borrowing and debt for the future, reducing governments' fiscal space and their ability to deliver essential services. In addition, PPP projects often create infrastructure or services that come with user fees to generate revenue, which can effectively exclude poorer citizens.

While PPP promoters emphasise their potential benefits, notably their professed efficiency gains in the provision of public goods and services, little attention has been devoted to analysing one of the main drivers of

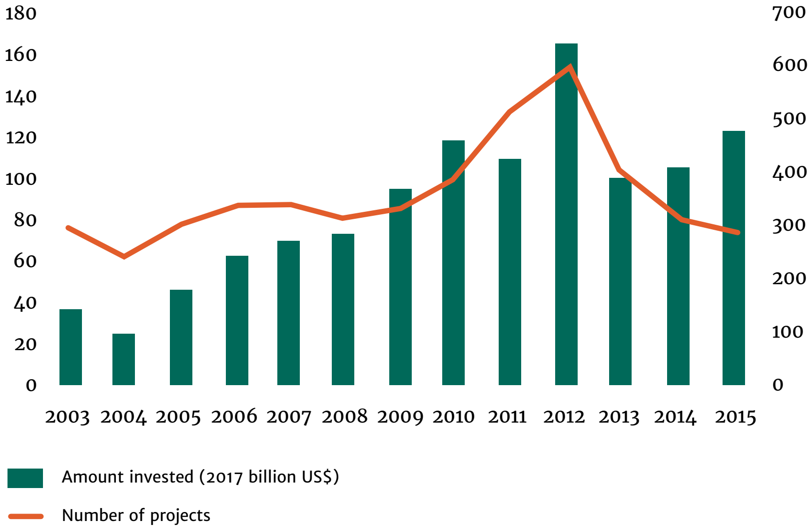
PPPs: their use by governments to hide public debt through non-transparent accounting practices, and the resulting long-term consequences. In this article, we warn decision makers and citizens against the financial and social costs of PPPs and call for assessing the long-term real costs of PPPs in a transparent way.

How important are PPPs?

The last decade has seen a dramatic increase in the amount of money invested in PPPs in the developing world. As Figure 1 shows, between 2004 and 2012 investments through PPPs increased six fold: from US$25 billion to US$164 billion. Although investments in PPPs fell in 2013 to US$99 billion, it has continued to be on the rise since 2014, with US$122 billion invested in 2015.

Importantly, it is not just the number but the scale of the projects financed through PPPs that has increased throughout the years. From 2003 to 2015 the average size of projects increased drastically from US$124 million to US$422 million. This is consistent with a decade-long trend toward mega-projects, which has been critically analysed by Bent Flyvbjerg from Oxford University's Said School of Business, among others. He notes that the risks and complexities multiply along with the scale of the projects. Delays are particularly problematic in larger projects, and they cause both cost overruns and benefit shortfalls.[1]

Figure 1. *Total investment in PPPs and number of projects in the developing world, 2003-2015 (billion dollars in real terms)*



Source: Eurodad's own calculations based on Private Participation in Infrastructure Projects Database (*adjusted by US Consumer Price Index)

When considering country income groups within the developing world, Eurodad analysis reveals that 66 per cent of investment in PPPs was undertaken in upper middle-income countries (UMICs), 33 per cent in lower middle-income countries (LMICs), and just 1 per cent in low-income countries (LICs). In other words, PPPs tend to be more common in countries with large and developed markets to allow for a faster recovery of costs and more secure revenues. Yet the meagre percentage of total investment in PPPs flowing to the world's poorest countries does not mean that PPPs are not relevant in these countries. In fact, when measured by taking into account the size of the local economy (GDP), investment in PPPs has been relatively higher in LICs than in UMICs. This pattern might indicate that LICs are more vulnerable to the fiscal implications of PPPs that are discussed in this article.

The critical players in the field of PPPs

A wide range of institutions, donor governments and corporate bodies have been actively calling for an increased use of PPPs in developed and developing countries. At the global level, PPPs featured prominently in the Addis Ababa Action Agenda that came out of the 2015 UN Conference on Financing for Development,[2] and are specifically promoted as a 'means of implementation' of the 2030 Agenda for Sustainable Development.[3] The Group of 20 (G20) also has a work stream to promote PPPs in infrastructure, using the G20 Global Infrastructure Initiative and the Global Infrastructure Hub, launched under the Australian presidency of the Group.[4]

At the European level, governments are increasingly interested in using PPPs as a way of delivering development assistance, which in practice can also help to create business opportunities for European companies.

Multilateral development banks also play a leading role in the field of PPPs, particularly the World Bank Group (WBG). They have set up multiple initiatives to provide advice to governments to change their regulatory framework to enable PPPs, and to finance specific PPP projects, including projects in health care and education that undermine people's access to these services.[5]

In 2014 the WBG set up its own Global Infrastructure Facility, a partnership among governments, multilateral development banks, and private sector investors designed to facilitate the preparation and structuring of complex infrastructure PPPs, and in 2016 the WBG committed to serve as the secretariat of the Global Infrastructure Connectivity Alliance. The WBG also plays a critical role when developing policy guidelines that countries often take as a reference. These include a "Framework for Disclosure for PPP Projects," a report on "Recommended PPP Contractual Provisions," and more recently, guidelines on "Unsolicited proposals." However, given the development mandate of these institutions, their activity in this field should be seriously scrutinised.

The fiscal costs of PPPs

PPPs are, in most cases, more expensive than traditional public procurement. This is due to the cost of capital, profit expectations by the private sector companies, and transaction costs to negotiate complex PPP contracts.

The cost of capital is usually more expensive in PPP projects than in public sector works, because national governments can usually borrow money at lower interest rates than private sector companies. In the UK, a 2015 review by the National Audit Office found "that the effective interest rate of all private finance deals (7-8%) is double that of all government borrowing (3-4%)." In practice, this means that the cost of capital of PPP-operated services or infrastructure facilities is two times more expensive than if the government had borrowed from private banks or issued bonds directly.

Moreover, private sector companies are expected to make a profit on their investment, which means an increased cost for the public purse and/or for users. The non-profit organisation Counter Balance revealed that the 215 PPPs supported by the European Investment Bank between 1990 and 2015[6] generated typical annual profits of 12 per cent. For PPPs in the global South, where the risks are perceived to be higher, investors expect 25 per cent or more. According to Nicholas Hildyard, author of the report, PPPs are essentially "a rent-seeker's dream."[7]

PPPs are also very complex arrangements with high costs associated with negotiating, preparing and managing the projects. They entail considerable legal and financial advisors' fees to structure and negotiate the deal. For instance, as the *Financial Times* reported in 2011, "lawyers, financial and other consultants have earned a minimum of £2.8bn and more likely well over £4bn in fees over the past decade or so getting the projects up and running."

PPPs are all too often renegotiated: according to International Monetary Fund (IMF) staff, 55 per cent of all PPPs get renegotiated, on average two years after the signing of the contract, and 62 per cent of these result in increased tariffs for the users.[8] Renegotiation of contracts leads to lack of competition and transparency, and opens the door for corrupt behaviour. Shaoul (2009)[9] argues that limited competition creates increased risk for the public sector because the companies are large and powerful enough to take on the regulators in case of conflict, and force contract renegotiation on more favourable terms. For instance, as a result of the massive corruption investigation with a focus on the Brazilian construction giant, Odebrecht, *The Economist* revealed that the main method for the company to win contracts was to make low bids and "then corruptly secure big increases in costs through addenda – in some cases when the ink on the contract was barely dry."[10]

In addition to higher financial costs, the historical experience of several countries (in both developed and developing countries), shows that the fiscal implications of PPPs come from both direct liabilities and non-transparent contingent liabilities (or risk of debts in the future). Direct liabilities are the payment terms set in the contract, which can include, for example, "viability gap payments," that is capital contributions to ensure that a project that is economically desirable but not commercially viable can proceed. On the other hand, contingent liabilities are payments required from governments if a particular event occurs. This can be a fall in the exchange rate of the domestic currency or a drop in the demand under a specified level. As such, the occurrence, value and timing of these payments are outside the control of the government. Most of the time they are non-transparent to the public – or even to national parliaments – as they are not easily and fully quantified, which makes PPP projects a risky business.

As a result of contingent liabilities, the true costs of PPPs can be enormous. Governments often provide different types of guarantees to attract private investors, but these can create a significant burden in the future. These guarantees range from loan repayments, minimum income streams, guaranteed rates of return, guaranteed currency exchange rates and compensation should new legislation affect an investment's profitability.

PPPs have already left lasting fiscal legacies in countries such as the United Kingdom,[11] Portugal,[12] Hungary,[13] Ghana, Tanzania, Uganda,[14] Peru and Lesotho,[15] where a PPP hospital swallowed up half of the country's health care budget while giving a high return of 25 per cent to the private sector company. Experience also shows that the fiscal implications of PPPs can exacerbate or even precipitate major financial crises. As the World Bank acknowledges "all PPP road projects in countries affected by macroeconomic crisis (Greece, Portugal and Spain recently, and previously Malaysia and Mexico) simultaneously suffered demand challenges (and faced bankruptcy risk) creating a systemic risk."[16] The decrease in the demand for the PPP service arises as a result of lower economic activity during the crisis, which results in a knock-on effect on the public sector.

While PPP supporters acknowledge the additional financial costs already mentioned, they argue that these are justified in terms of efficiency gains. In some cases the efficiency gains of PPPs come from improvements in design, construction and operations. There are some studies that refer to these gains, but the evidence is not conclusive. Importantly, in most cases, efficiency gains depend on the sector, the type and size of projects, the private sector increasing capital investment as stated in the contract, and the country's context in terms of regulatory environment and good governance.

Box I

Remunicipalisation as a result of fiscal costs of PPPs: The case of the UK

One of the first countries to develop PPPs was the UK, where they are known as Private Finance Initiatives (PFIs). The idea behind PFIs was to attract private investments in public projects to keep spending "off balance sheet" of the public sector. Yet research has shown that many PFIs have left lasting fiscal implications.[17] For instance, a 2017 report by the European Services Strategy Unit (ESSU)[18] found that the public costs of buyouts, bailouts, terminations and major problem contracts is £27.902 million. ESSU calculated that this could have built 1,520 new secondary schools for 1,975,000 pupils, 64 per cent of 11-17 year old pupils in England. The report also found that nearly one in 10 Scottish PPPs has had to be terminated, bought out by the public sector or continues to exist with major problems. For example, the East Lothian schools project overseen by Ballast UK went into administration in 2003 while in the process of refurbishing six schools and community centres. However, after the parent company withdrew its funding, subcontractors went unpaid and ended up liquidating their assets as Ballast had a 50 per cent share of the infrastructure investment – adding even more fiscal costs to the public purse.

Box II

Remunicipalisation as a result of fiscal costs of PPPs: The case of Indonesia

In 1997 the Indonesian government entered into two PPP contracts of 25 years with subsidiaries of multinationals Suez and the Thames Water. According to a report published by the Public Services International Research Unit, Transnational Institute and Multinational Observatory,[19] both PPPs failed to live up to expectations, partially because of the detrimental fiscal costs that quickly arose. After 16 years of ongoing operations, Pam Jaya, the public water company, and the government accumulated at least US$48.38 million of debt. Payment agreements set out in the PPP contract included a continuously increasing water charge paid by Pam Jaya to the private operators. Meanwhile, user fees have gone up tenfold in Jakarta – the highest water tariff in South-East Asia. In 2012, the Coalition of Jakarta Residents Opposing Water Privatisation filed a citizen lawsuit that would require the government to terminate both PPP contracts. And with success: In 2013 the government announced that the city of Jakarta would remunicipalise some water services by buying back Suez's shares. In 2015 the Central Jakarta District Court ultimately annulled the contract with Suez arguing that the PPPs failed to fulfil the human right to water for Jakarta's residents. However, this decision was challenged by the defendant and the case is still on trial.

Perverse accounting incentives

Given the complexities of PPPs and their detrimental fiscal costs, one could ask why countries prefer PPPs over the public borrowing option. Proponents of PPPs often argue that the participation of the private sector leads to higher quality investments and allows states to spread the costs instead of having to raise funds upfront as happens in the case of traditional public procurement.

However, Eurodad research shows that one of the key drivers of governments' opting for PPPs is that non-transparent accounting measures allow them to keep the costs and liabilities of PPPs "off balance sheet." In other words, their costs are not registered in the government's budget balance sheet, which means that the true cost of the project remains hidden. As the IMF's website states: "in many countries, investment projects have been procured as PPPs not for efficiency reasons, but to circumvent budget constraints and postpone recording the fiscal costs of providing infrastructure services," which ends up exposing public finances to excessive fiscal risks. By using such perverse accounting practices governments create the dangerous illusion that PPPs are cheaper than they really are. Politicians use PPPs to green light projects that have been promised to their electorate, while keeping their budget under control and abiding by legislated budgetary limits.

The European Commission has warned against the 'affordability illusion' of PPPs, while experts within the IMF's Fiscal Affairs Department have publicly criticised these incentives and the risks posed by PPPs, explicitly calling for the institutional framework for managing the fiscal risks of PPPs to be strengthened. Importantly, as Tao Zhang, IMF Deputy Managing Director stated in a conference in Australia in December 2016, "there are significant fiscal risks. PPPs are not 'infrastructure for free'."[20] Unfortunately, these warnings have not been voiced strongly enough for multilateral development banks to refocus their approach to infrastructure finance toward increasing the efficiency of public service delivery.

The way forward

Eurodad has been calling for strong international guidelines on PPPs to ensure they serve development objectives. These should include full disclosure of contracts, an explicit endorsement of 'on balance sheet' accounting and reporting of PPPs, and a detailed and transparent cost-benefit analysis that sheds light on the long-term implications of PPPs, for both the public sector and users, considering social, environmental and fiscal costs.

In response to the leading role of the WBG, in February 2017 a group of more than 110 non-governmental organisations and trade unions from all over the world sent a letter to the World Bank PPP team and Executive

Directors announcing that they will no longer participate in public consultations on PPPs until the WBG drastically changes its current approach to PPPs. Given the development mandate of the WBG, the institution has a responsibility to ensure that governments select the most fiscally sustainable financing mechanism to deliver infrastructure projects.[21]

Governments and financial institutions should focus on developing the right tools at the country level to identify whether – and under what circumstances – it is desirable to choose PPPs instead of traditional procurement. This implies that they should choose the best financing mechanism, including examining the public borrowing option, and should stop hiding the true costs of PPPs, by reporting in national accounts and statistics the costs of the project and its contingent liabilities. This will boost the transparency of the decision-making process and increase democratic accountability.

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