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International Experience in Public-Private Partnership

Tarhan Feyzioğlu
Resident Representative
International Monetary Fund

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Outline

- PPPs have potentially large fiscal risks
- Managing fiscal risks
  - The gateway process in South Africa
- Private Financing Initiative
  - Private equity and debt

PPPs: Public-Private Partnerships

- Arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the government.
- Main characteristics:
  - Private execution and financing of public investment
  - An emphasis on investment and service provision by private sector
  - Risk transfer from government to private sector

PPPs have potentially large fiscal risks.

- Infrastructure “for free”? Tempting, particularly for cash strapped governments trying to meet fiscal targets.
- Fiscal risks could be large because:
  - PPPs move spending off budget and can create contingent liabilities for the government
  - PPPs potentially threaten integrity of budget process, and undermine efforts to safeguard macroeconomic sustainability
  - PPPs potentially complicate maintaining fiscal discipline and good governance

Fiscal risks: Selecting wrong projects

- Shadow-toll highways in Portugal
  - Government pays the operator for traffic use, collects revenue from gasoline sales, special tax assessment of nearby real estate etc.
  - Originally approved and contracted only because they were perceived by decision makers to be “zero cost” projects.
  - Faced with a significant cost burden on the budget, the government decided to apply tolls to those roads.
  - If the projects’ life-cycle costs had been properly assessed, it is likely that other highway projects with much lower cost-benefit ratios, would have been selected.

Fiscal risks: Design problems

- London University College Hospital
  - Hospital to be built with private funding
  - Sir Ronald Mason, Chairman of The UCL Hospitals NHS Trust: "This is a dream come true for our part of London and is the result of a remarkable partnership between the health service, the university, the private sector and various charities."
  - After construction had been completed, ventilation system had to be changed to accommodate the most recent version of imaging equipment (which emitted more heat).
  - Government had to pay additional millions of British pounds.

Fiscal risks: Bankruptcy

- M1 highway in Hungary
  - Heralded as Euromoney magazine's 1995 "finance project of the year"
  - But: traffic forecasts had been too optimistic
  - In 1999 the project was nationalized
- Mexico
  - In the early 1990s, ambitious program of private toll road concessions
  - Most concessionaires soon ran into financial difficulties owing to both cost overruns and traffic shortfalls
  - Government relief efforts included extension of the term of the concession, direct budget support, and income tax credits.
  - In 1997 took over the concessions and assumed about $7.7 billion in debt.

Managing Fiscal Risks

- Effective mitigation of fiscal risk + efficiency gains

- Governments can control these factors:
  - Good projects (choose projects that provide *value for money*)
  - Good laws (EBRD's Legal Indicator Survey and Sector Laws Assessment)
  - Good institutions (establish due-diligence/multi-stage gateway process with strong role of Finance Ministry)
  - Good fiscal accounting and reporting (transparency)

- Public Investment and Public-Private Partnerships (2008) by Gerd Schwartz, Ana Corbacho, and Katja Funke (IMF publication)

The gateway process in South Africa
Phase 1: Inception

- Register project with the finance ministry
- Appoint project officer
- Appoint transaction advisor

The gateway process in South Africa
Phase 2: Feasibility study

- Prepare a feasibility study comprising the following
  - Needs analysis
  - Options analysis
  - Project due diligence
  - Value assessment
  - Economic valuation
  - Procurement plan
- GATEWAY: Approval No 1 by the finance ministry

The gateway process in South Africa Phase 3: Procurement

  - Design procurement process to be fair, equitable, transparent, competitive, and cost effective
  - Prepare bid documents, including draft PPP agreement
- GATEWAY: Approval No 2a by the finance ministry
  - Pre-qualify parties
  - Issue request for proposals with draft PPP agreement
  - Receive bids
  - Compare bids with feasibility study and each other
  - Select preferred bidder
  - Prepare VfM report
- GATEWAY: Approval No 2b by the finance ministry
  - Negotiate with preferred bidder
  - Finalize PPP agreement management plan
- GATEWAY: Approval No 3 by the finance ministry

The gateway process in South Africa Phases 4 - 6

- Phase 4: Development
  - PPP agreement signed
  - Measure outputs, monitor and regulate performance, liaise effectively, settle disputes
- Phase 5: Delivery
  - Report progress in the annual report
- Phase 6: Exit
  - Scrutiny by the Auditor-General’s Office

Private Finance Initiative (PFI) in the United Kingdom

- Begun in earnest in late 1990s.

- 625 PFI projects in operation as of 2008, with a total capital value of $85 billion, including hospitals, schools, transport projects, fire and police stations, waste and water projects.

- Small share of total investment (about 10 percent).

- Delivered mostly by local governments.

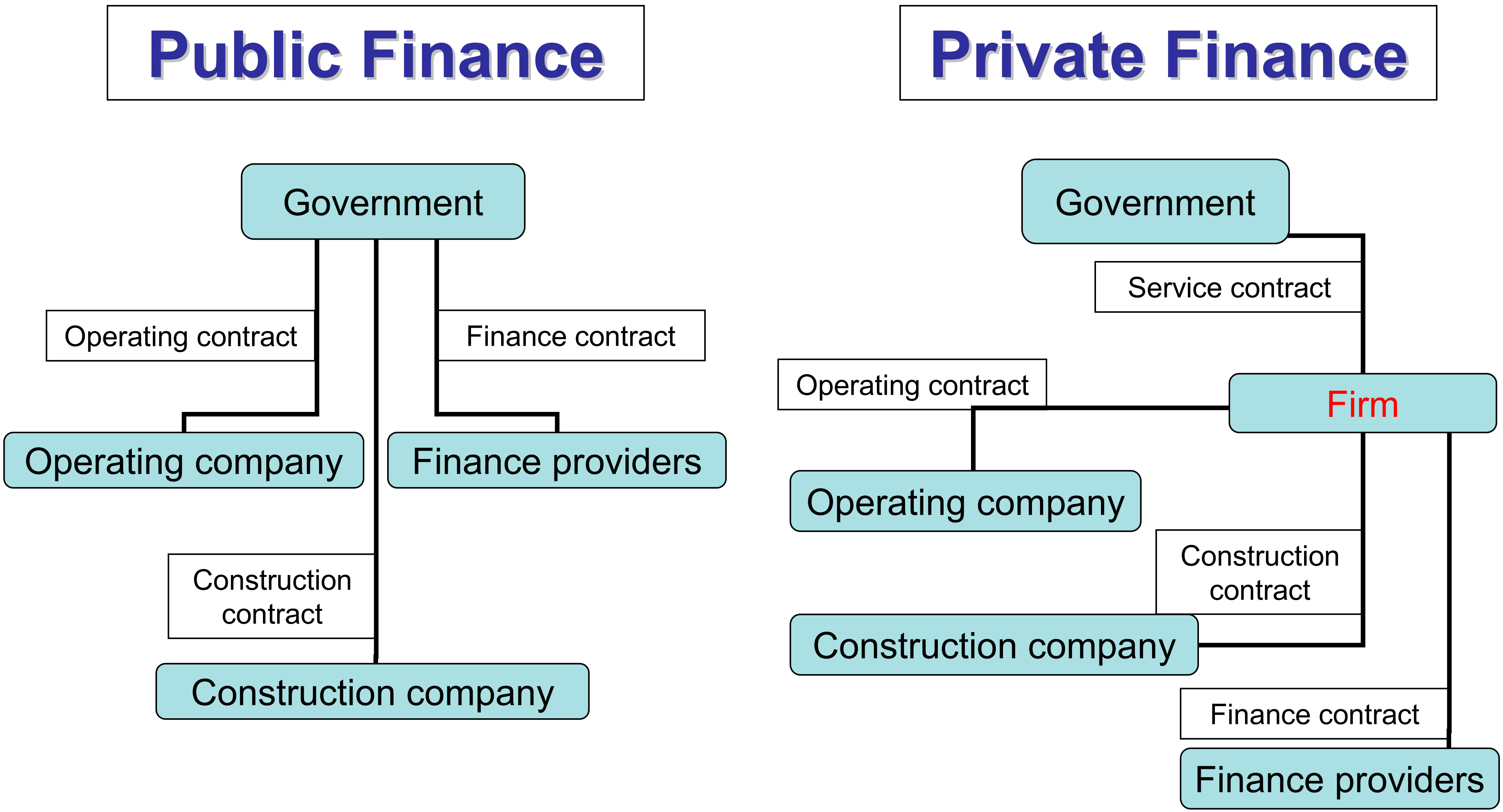
PFI example: M6 toll road

- The M6 Toll Road
  - A freestanding concession with no ongoing government financial involvement.
  - The concessionaire generates investment and return from direct user charges.
  - Government has transferred risks, such as planning, design, construction and revenue risk, to the concessionaire.
  - The contract is for 53 years and at expiry the asset will revert to the public sector at no cost.

PFI example: St. James' University Hospital

- The PFI scheme at St James' University Hospital in Leeds (the largest teaching hospital in Europe)
  - Capital value of £265 million.
  - Contract for 30 years.
  - The private sector partner providing the following:
    - built a new wing;
    - refurbished and adapted other parts of the existing hospital;
    - provides a wide range of other services, including specialist surgical services, clinical and non-clinical support services;
    - is responsible for the provision and maintenance of medical equipment;

For private financing to work, all links to the firm need to be strong.



Private Finance Initiative (PFI) in the United Kingdom

- The public sector specifies the outputs it requires and a private sector consortium then contracts to meet those requirements. (ex: kilometers of highway, beds for a number of patients)

- The risk involved in the project is shared between the parties, with each party managing the risks they are best able to. This approach to risk-sharing provides powerful incentives for the private sector to perform, and ensures value for money for the public sector. (ex: government (sometimes) takes the risk on traffic volume, number of patients; private sector takes the risk on construction, cost overruns, operational costs of toll collection)

- The public sector ensures the quality and continued effective delivery of public services is maintained, with the ability to make deductions for poor performance, the flexibility to make necessary changes in future, provisions for the consortium or fund providers to replace poor service providers, and ultimately the right to terminate the contract.

- The Special Purpose Vehicle (SPV) uses private finance, usually a mix of equity and debt, to fund the up-front construction works.

Equity providers

- Invest in ordinary shares or subscribe for long term subordinated debt.
- Typically approximately 10 per cent of the project's up-front costs.
- The element of the financing most at risk to loss.
- Usually provided by those providing services to the PFI project (e.g. the construction contractor, long term facilities manager, specialized financial institutions).
- An equity investor only benefits from its investment in a PFI project after it is complete and successfully in operation as unitary charges are only paid once an asset becomes available. This enables construction contractors to take a long-term interest in the project, even after they have completed their construction task.
- But: UDIC's are owned by local governments; therefore this incentive is weak.

Senior debt

- Typically, third party credit providers are more risk-averse than equity providers and provide the majority of the funding.

- The PFI approach and process thus leads banks and other financial institutions who lend to PFI projects to play a important role in ensuring that
  - Proper due diligence is performed.
  - All important risks are identified and properly addressed and allocated to the appropriate parties.
  - They will seek to have robust and rigorous contractual undertakings from private sector participants in the PFI scheme.

The price of risk: public vs. private sector

- The "risk free" cost of government debt is not directly comparable with the cost of private finance.
  - Typically, the private sector takes account of risk by discounting future cash flow at a higher rate. In PFI, the project discount rate, or expected rate of return for the private sector, takes into account the costs associated with procuring private capital and also seeks to price the wider risks associated with lending to the project.
  - The interest rate on government debt does not include risks. This does not mean that the Government is able to borrow and spend money free of risk. Instead it means that the taxpayer takes on the risk attached to the project, and where it materializes, bears the cost as a result.
  - Government investment decisions reflect risk by calculating the present value of capital needed for the risks inherent in a project. When deciding between procurement options, project managers calculate an expected value of all risks for each option, and consider how exposed each option is to future uncertainty.

Concluding Remarks

- International experience shows that private financing of public investment entails large fiscal risks, which often materialize.

- These fiscal risks are manageable, but requires good institutional setup. Useful examples include
  - The gateway process in South Africa (www.ppp.gov.za)
  - Private Finance Initiative (www.hm-treasury.gov.uk/ppp_index.htm)

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