# Hurdles to PPP investments

## A contribution to the Third Pillar of the Investment Plan for Europe

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# Background and purpose of the paper

This paper discusses some of the most frequent hurdles to delivering public investment projects through public-private partnerships (PPPs) in Europe.[1] It summarises contributions made by the European PPP Expertise Centre (EPEC) in several fora in the context of discussions on the Third Pillar of the Investment Plan for Europe.[2] The hurdles addressed in this paper are illustrative of the kind of issues the European PPP market faces rather than an exhaustive representation of them. Many hurdles are linked to the underlying investment projects (e.g. poorly prepared projects, delays/failure to obtain authorisations, poorly conducted public consultation processes) rather than to their delivery as PPPs. This paper does not discuss these project hurdles, which in themselves can be significant.

For the purposes of this paper, a PPP refers to an arrangement between a public authority and a private partner designed to deliver a public infrastructure project and service under a long-term contract. Under this contract, the public authority makes a performance-based payment to the private partner for the provision of the service (e.g. for the availability of a road) or grants the private partner a right to generate revenues from the provision of the service (e.g. tolls from users of a bridge). Private finance is usually at risk.

Member States that have used PPPs for some time and through a number of project programming cycles have generally been able to deliver efficient and effective PPP projects. Given its purpose, this paper deliberately focuses on the hurdles to the use of PPPs in EU Member States where PPPs are not, thus far, widespread or common.

## 1. Political commitment to engage in PPPs

PPPs are a fundamentally different way of delivering public assets and services and, as such, require governments to introduce new practices and counter unfounded internal and external opposition. As long-term contractual commitments, they often do not sit comfortably within the existing administrative framework of government, frequently requiring new and separate structures for their management and implementation. It is therefore common for governments to underestimate the political commitments and resources required to put in place and implement successful PPP programmes and projects. This political commitment needs to be strong and stable if both the public and private sector partners are to be expected to devote significant resources to preparing, investing in and implementing projects. There are many examples in the EU of short-lived, weak or changing political commitments to PPPs which harm stakeholders' interests and hinder the development of sound PPP project pipelines. There are also examples of promotion of unrealistic pipelines (e.g. in terms of capacity or affordability) which undermine the credibility of the PPP programme.

PPPs can also be the subject of uninformed or erratic political decisions. For example, there are many cases of political pressure to proceed with PPP proposals more quickly than is feasible (without recognising the time and resources required to prepare and procure them adequately as PPPs) or to opt for a PPP delivery where the underlying

1 This paper draws from EPEC's report on "PPP Motivations and Challenges for the Public Sector", see: www.eib.org/epec/resources/publications/epec_PPP_motivations_and_challenges_en

2 The objective of the Third Pillar of the Investment Plan for Europe is to remove barriers to investment and create simpler, better and more predictable regulation in the EU.

investment project may not justify it. There are also cases in the EU of political pressure to renegotiate the terms of signed contracts, to change the regulatory frameworks in which PPPs sit, and even to terminate PPP contracts ahead of maturity.

## 2. Legal, regulatory and institutional frameworks, policy formulation

It is widely recognised that, in common with all large-scale public investment programmes, to be successful, PPPs require conducive legal, regulatory and institutional frameworks and processes. The hurdles in this field are multiple and often interdependent, for example:

- Legal/regulatory frameworks: PPP projects require an effective legal framework, in particular to regulate the ability to use PPP schemes, the procurement process and key contractual provisions. Although a PPP law is sometimes considered a necessary prerequisite, especially in countries with civil code systems, PPP laws are sometimes insufficiently informed by experience from existing PPP markets and can inadvertently put inappropriate/excessive restrictions on PPP activity. For example, there are several laws in the EU that seek to define the quantum of compensation due to the private partner on early termination of the PPP contract but, as the law-making process did not foresee the consultation of stakeholders, these laws have brought about Value for Money or bankability issues;

- PPP approval processes: clearly defined powers and processes in the public sector are a prerequisite for the appropriate selection and subsequent effective management of the various phases of PPP project development. There are many cases of immature/inadequate projects progressing to the tender phase or contract signature without an effective oversight of the team responsible for delivering the PPP, including appropriate public spending control (e.g. no involvement of the Ministry of Finance at key stages of the project development). These projects will often fail to reach financial close or face significant issues during their contract life; and

- Communication and public acceptability of PPPs: the complex technical nature of PPPs can create a misunderstanding of their likely benefits and the rationale for their use. For example, PPPs are sometimes seen as a proxy for the privatisation or outsourcing of public services. As a result, PPPs can be associated with a wider debate around issues such as the private sector generating unreasonable profits from the provision of public services. Although most PPPs are successful in delivering high quality facilities on time and within budget and in providing improved services, the successes achieved are often weakly demonstrated (usually because of the absence of collected evidence) such that even in mature PPP markets, an understanding and acceptance of PPPs can be lacking. There are also cases of deficient management of stakeholders – and in particular their concerns and expectations – which can lead to avoidable opposition or protests (either against the project itself or its delivery as a PPP). While the issue is not unique to PPPs, the role of the private sector in the project can magnify objections.

## 3. Capacity of the authority responsible for delivering the PPP

PPPs involve complexities at all stages of the project cycle (preparing, procuring, financing and managing performance-based contracts) and require a wide range of skills, some of which may be new to the public sector or difficult to attract and retain in the public sector. In particular, PPPs require significant preparatory analysis ahead of procurement launch (e.g. Value for Money analysis, risk analysis, bankability analysis). Public authorities responsible for developing PPPs are often not equipped or unaware of the required skills and resources needed to meet the challenges. In the absence of a programme of investment, many will procure one or two PPP projects only, which makes the sunk costs of building internal capacity significant. There is also, at times, some reluctance to use advisers, with budgetary constraints preventing the recourse to appropriate advisers or a poor ability to manage advisers where these are mandated (e.g. over-reliance on advice).

Weaknesses in the capacity of authorities to prepare projects can have a significant impact on their deliverability. Many examples of hurdles can be quoted in this area:

- Authorities sometimes propose poor investment projects (e.g. investments with a weak socio-economic case or a poor social acceptability) as PPPs in the hope that the private sector will be able to offer solutions to what are fundamentally project issues. In other words, a PPP delivery is chosen not because it is the most appropriate way to deliver the specific project but, rather, to try to overcome issues that cannot be addressed by delivering it conventionally. This is for example the case of:
    - transport projects underpinned by a weak demand analysis or overestimated demand levels;
    - projects for which government is unable to identify or commit sufficient "funding" sources (i.e. user payments, capital contributions from the public sector, budgetary allocation to support "availability payments") to cover the costs;
    - projects where there is poor stakeholder buy-in (e.g. lorry drivers on road charging schemes);
- There are many cases of project proposals for which the "PPP business case" prepared by the authority in charge fails to address key issues satisfactorily. To name a few:
    - the PPP option being selected too early on a weak analytical basis;
    - poor analysis of affordability for the public sector over the long term;
    - shortcomings in the risk analysis, which overestimates the ability of the private sector to take on risks in an efficient manner (e.g. latent defects of an existing infrastructure to be refurbished by the private partner);
    - no sounding of the market during project preparation to assess the feasibility and the terms upon which unusual risks may be allocated to the private sector;
    - using a PPP scheme where it is not suitable, for example on projects with high technological content, significant obsolescence risks or uncertain service requirements through time; and
- In a number of jurisdictions, PPP contracts tend to be inadequately designed or unclearly drafted (e.g. ambiguous allocation of risks, inappropriate early termination provisions).

A poorly prepared PPP will frequently fail to reach contract signature or financial close. If it does, it will often lead to a poor Value for Money outcome for the public sector mostly because of poor competitive tension.

## 4. Capacity and buy-in of the private sector

A number of EU markets have a limited domestic market where the technical or financial capacity of contractors, service providers, investors, lenders and advisers to deliver PPPs is not well developed. As a consequence, PPP procurement does not always provide the necessary level of competition or quality of bids (e.g. there is limited bidder interest or a single bidder only), which will in all likelihood lead to a poor outcome for the public sector. Market capacity issues also affect the effectiveness of a key incentive in PPPs: the ability of the public authority to replace the private partner if it were to fail during the contract life.

In some jurisdictions, a major capacity constraint may be the availability of domestic financiers or contractors to support PPP projects with long-term project finance or equity. For example, commercial banks may not have secured the skills required to engage in unfamiliar limited-recourse project financing transactions, setting aside liquidity issues (see point 7 below).

Finally, the size of the project can be a challenge for PPPs. PPP projects usually need to be of a certain minimum size to justify the transaction costs that are involved and attract the interest of bidders and associated financing. On the other hand, projects that are too large can also face constraints in the contracting (or financing) pool available.

## 5. Procurement

PPPs are complex contracts to procure. By focusing on service outputs and allowing more scope for the private sector to decide how best to deliver against these outputs, PPPs create incentives to innovate and to maximise efficiency in delivering public services. As a result, the way in which a PPP contract is procured is key to obtaining Value for Money. Indeed, effective competition will drive costs down and boost private sector innovation. In certain markets or for certain projects though, the PPP procurement has not been effective in capturing the benefits of competition and private sector innovation. This is particularly the case where overly prescriptive tender process requirements have been set and inappropriate procurement procedures have been used. Competitive dialogue and the negotiated procedure (recently replaced by the "competitive procedure with negotiations") have both shown their potential to deliver value when properly designed and managed. Clearly though, the open and restricted procedures are far less suited to PPPs. There are several examples of markets and projects in the EU where the restricted procedure has been used and significantly constrained the private sector bidders response (e.g. poor communication and so understanding of the public sector requirements, too little time left to prepare the offers, no prior lenders' commitment, no possibility to propose changes to the draft PPP contract made available to bidders).

It is also worth stressing that apparently frivolous legal challenges against the procurement process are frequent in certain EU jurisdictions as the legal framework in place does not deter challenges or enable their prompt resolution.

Finally, and despite the significant efforts of the European Commission to make public procurement clearer through the recently adopted directives on public procurement and concessions, a number of important issues remain for PPPs. For example, there is a question over whether the types of risks transferred under a PPP, in particular an availability-based PPP, mean that the project should be procured as a concession or a public works/services contract. Also, although the Public Procurement Directive simplifies some procurement issues for public authorities, some ambiguity remains in a number of areas, such as post-tender changes.[3]

## 6. Statistical (Eurostat) treatment and management of PPP fiscal risks

It is often argued that the rules on the statistical treatment of PPPs (commonly referred to as "Eurostat rules") are a hurdle to PPPs, as they make it difficult to classify PPPs off the balance sheet of government under Maastricht criteria. Many stakeholders have also expressed concerns regarding the clarity and rationale of the some of the rules, the unpredictability in their interpretation and the frequency of changes given that PPPs have long gestation times.

These allegations should however be tempered, at least on two accounts:

- An excessive focus on the off-balance sheet treatment can be at the expense of sound project preparation, Value for Money (the allocation of a particular risk to the private partner may help the statistical classification but may not be appropriate) and may push procuring authorities to use PPPs where this is not appropriate; and

- PPPs create an "affordability illusion" (due to the deferral and spreading of public sector payments through time), which is exacerbated when a project is found to be off-balance sheet. When a project is off-balance sheet, there is a risk that the fiscal liabilities that arise from it are not managed properly (e.g. recognition of government financial commitments, whether firm or contingent, explicit or implicit).

Although it is difficult to assess the extent to which sound and properly prepared PPPs in countries

3 See EPEC's report on the subject: www.eib.org/epec/resources/publications/epec_ppp_and_procurement_en

that have adequate PPP fiscal management frameworks have not been able to proceed because of their statistical treatment, some may still fall into this category. [4]

## 7. Funding and financing

All PPP projects have to be paid for at some point, regardless of how they are financed.

When talking about "funding", reference is made to the sources of cash that ultimately bear the cost of projects. These sources broadly form two groups: tax-payers (whose taxes enable governments, for example, to make capital contributions or availability payments to PPP projects) or users (who may for example pay a toll to use a highway). "Financing", on the other hand, is money that must be paid back (e.g. loans or equity). Finance is used to bridge the gap between project inception, when funding may not be sufficient, and later when resources are eventually available to pay for the project. As a result, contrary to what is widely believed, a financing instrument, however sophisticated, will not address a funding issue.

In today's market, raising finance is far less of a constraint than it was during the financial crisis. In many EU PPP markets there is significant liquidity available such that debt and, to a lesser extent equity, can be raised for well-prepared PPPs on attractive terms (although, in some markets, there may still be capacity constraints among domestic lenders). De facto, a more significant hurdle to PPPs (possibly the biggest) is that of the funding of projects. In the current environment, public budgets and users' unwillingness to pay for public services are such that the long-term affordability of PPP projects is challenged. And, as public decision-makers sometimes forget, the funding issue remains whether the PPP is recorded on or off the balance sheet of government.

On the question of funding, the potential role of EU funds in PPPs should be highlighted.[5] Where eligible, EU funds could help address the funding gap of projects delivered as PPPs. The latest regulations on EU funds provide significant improvements to the possibility of blending EU funds and PPPs although it is still early days to judge how these will work in practice.

## Conclusion

As illustrated in this paper, many factors can inhibit the successful delivery of PPP projects. It is realistic to assume that the effective resolution of most of the PPP hurdles is a task of Member States rather than European authorities. In mature PPP markets, governments and procuring authorities have found ways to address a number of these constraints. Experience shows that some of these hurdles can be resolved if there is political will.

4 EPEC and Eurostat have recently published a guide to the statistical treatment of PPPs. The guide is expected to significantly help public authorities to take well-informed PPP procurement decisions as a result of better understanding of the statistical rules on PPPs. See: www.eib.org/epec/resources/publications/epec_eurostat_guide_ppp

5 See EPEC's paper on the subject: www.eib.org/epec/resources/blending-ue-structural-investment-fund-ppp

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