

Drawbacks of PPP

Most developing countries have not developed PPP projects or programs in the highways sector and those that have are largely concentrated in middle-income countries. Despite their significant potential, initial expectations for the size and pace of PPP development have not been met and development of PPPs is being constrained in many countries.

It is thus evident that a number of drawbacks, or difficulties, are impeding the development of PPP programs. If they are to attract the private sector into infrastructure provision and financing, governments need to fully recognize and address the drawbacks and their related constraints in the development of a PPP program.

Firstly, it is worth mentioning that a number of additional factors make highway infrastructure less amenable to PPPs than other types of infrastructure.

- For some types of infrastructure, such as local or urban roads, the physical difficulties of excluding users who do not pay, or the high transaction costs of implementing direct user charges, make it difficult to achieve a competitive market
- Where there are substantial externalities (such as road congestion and air pollution effects) that cannot easily be addressed by market-based instruments, there is greater likelihood of government intervention.
- When traffic flows are low, profitability from user charges is also likely to be low. Finally, some highway infrastructure is so intertwined with spatial planning that governments are not willing to leave it entirely to the private sector.

In order to secure the vital commitment of the public sector, users and of the population at large, the drawbacks of PPP need to be clearly understood and analyzed within the context of a given PPP program or project. The public authority must then define a communication strategy to ensure the potential drawbacks are not translated into public perception.

Complexity

PPPs are complex structures and complexity normally means higher costs. The number of players involved in the implementation of PPP (Module 1 -> Key Players and Roles) is indicative of the complexity and scale of the required level of analysis in order to prepare and manage the various components.

This complexity requires commitment on behalf of the public authorities to implement processes outside of their normal field of competence, associated capacity building measures within the public sector as well as an increased use of external advisors and expertise.

Long-term commitment

PPPs represent a long-term commitment between the public and private sector. Moreover, this is one of the key drivers of private sector efficiencies. However, it can present constraints for the public authority which need to be considered carefully.

- **Political commitment.** Political mandates are typically far shorter than the duration of a PPP project or of the period required to assess long-term benefits to the road sector.
- **Flexibility.** The commitment of the public authority may extend for 20-30 years. A PPP contract is of a type known as an “incomplete contract”, i.e. the contract cannot provide for all possible eventualities in the future. The longer and more complex the contract the more this is the case and therefore the more it is impossible for the public authority to abdicate or transfer responsibility for dealing with unforeseen circumstances.
- **Project design.** The concessionaire shall design the highway to a given standard of service. The public authority will not normally be able to impose a given method, technique or supplier which would comprise the concessionaire’s ability to assume life-cycle responsibility for the project.
- **Planning constraints.** PPPs require a stable, long-term planning horizon; this is generally the case for the highway sector but it may lead to conflicts. For example, non-compete provisions of a toll-road concession may prevent the public authority from undertaking other road improvements. Conversely, those projects where the public authority cannot clearly specify and stick to its requirements or where technology is changing rapidly, are not suitable for PPPs. This was the reason inter alia why the UK abandoned the use of PPPs for IT projects.

The potential cost to the public authority by the loss of flexibility are the cost of making major changes to the facility when there is effectively a monopoly supplier in place and the extra financial costs of terminating the PPP Contract if the facility is no longer required.

However, it must be remembered that when the public authority builds a highway, this in itself represents a long-term commitment; it cannot be knocked down or moved without considerable loss. PPP arrangements make this issue transparent.

Requirement for PPP Policy Framework and associated reforms

Implementation of PPP projects require the prior establishment of a PPP Policy Framework (Module 3 -> PPP Policy Framework). Several structural measures are likely to be needed to establish an enabling environment which may attract interest from the private sector for provision and funding of the highway infrastructure.

This initiation process will take time and there is a required inertia from the public sector to move the process forward, in spite of expected opposition from some political and social sectors. The key drivers shall be the ability to source additional funding for key infrastructure and the expected value for money gains from the private sector. The public commitment shall need to maintain the costs of the initiation process to implement PPP

framework and strategy in the face of competition with other more immediate needs on the public budget, notably for highway maintenance and investment.

In addition, PPP policy may accompany a wider restructuring of the road agency with a reduction in the number of civil servants and / or transfer to the private sector. If not carefully planned and conducted in conjunction with social measures, these programs can lead to de-motivation and opposition from road agency personnel.

Governments should seek the support of international institutions and funding agencies to support this process.

Transaction cost

PPP procurement costs can reach 5-10% of the capital cost for a reasonably large project and do not reduce pro rata for smaller projects. It follows from this that PPPs are not cost-effective for very small projects, unless they can be packaged together (in UK, projects of less than USD 40 million investment value are no longer considered for PPP). Equally, it is questionable whether PPPs are suitable for very large projects where the addition of extra complexity to the structure may make the project collapse under the weight of its own complications.

These contractual costs are not absent from conventional procurement but the agreements are less complex to draw up and are certainly less onerous to implement and monitor.

Dominance of foreign players in PPP market

PPP consortia are generally led by experienced international players with the required expertise and financial stability to assume the financing and risk of the PPP investment. This would be even more the case in developing countries. The predominant role of large foreign contractors may both have political implications and may directly affect the local contracting industry by restricting the implication of domestic players. However, it is evident that PPP developers shall need to rely on a wide array of domestic suppliers, contractors and consultants under sub-contracting arrangements.

TOP TRANSPORTATION DEVELOPERS 2006		
Company	Concessions / PPP Projects	
	Const. Operat- ing*	Active proposals
MIG / Macquarie Bank (Australia)	51	14
ACS Dragados / Iridium (Spain)	45	22
Ferrovial / Cintra (Spain)	44	34
Sacyr Vallehermoso (Spain)	29	19
FCC (Spain)	27	20
Albertis / La Caixa (Spain)	24	2
Vinci / Cofiroute (France)	21	26
Hochtief (Germany)	19	16
OHL (Spain)	17	10
Cheung Kong Infrastructure	17	4
Laing / Equion (UK)	15	2
Acciona / Necso (Spain)	14	18
Alstom (France)	13	6
Egis Projects (France)	13	10
Andrade Gutierrez (Brazil)	10	6
AMEC (UK)	9	6
Bouygues (France)	8	22
Bilfinger Berger (Germany)	8	9
Siemens (Germany)	8	8
Caja Madrid (Spain)	8	0
Bechtel (US)	7	5
Balfour Beatty (UK)	7	5
KBR Brown & Root (US)	7	3
BRISA (Portugal)	7	3
Skanska (Sweden)	6	10
Impreglio (Italy)	6	4
New World Infrastructure (China)	6	2
Alfred McAlpine (UK)	6	1
Fluor (US)	5	17
Bombardier (Canada)	5	6
Carillion (UK)	5	2
AMEY (UK)	5	5
Strabag (Germany)	5	14
Transurban (Australia)	4	7
ABB (Switzerland)	4	4

* road, bridge, tunnel, rail, port, airport concessions over 150m capital put under cost./oper. since 1985.

Source: Public Works Financing, October 2006

Increase in construction costs due to limited domestic market capacity

Large increase in demand for construction works on PPPs could cause problems in capacity in the domestic construction industry and lead to an increase in prices, thus offsetting other benefits which might have been derived from the PPP route. Significant increases in construction costs have been observed for schools and hospitals in UK and roads in Portugal, all sectors where there have been large PPP programs.

Similarly, the size and complexity of PPP projects discourage smaller contractors from bidding, so reducing competition, which may also affect the final cost.

However, this issue is more related to the overall volume of construction work in highways and other civil and building fields, rather than the use of the PPP route per se.

Introduction of user charges

Introduction or restructuring of user charges is sensitive. If not well designed and justified to road users and other stakeholders, it could result in loss of political support, complaints or even legal challenges. Tolling has a particular adverse psychological impact on road users.

The government needs to carefully assess the introduction of extension of its tolling strategy and determine acceptable toll levels.

Private profit at the public's expense

This is an often-heard criticism of PPP programs as it can prove difficult to counter in public perception. It is based on the premise that PPPs give private sector investors the opportunity to make profits by providing services which could have been provided by the public sector more cost-effectively. It may be reinforced in the event of government subsidies and the notion that taxpayer's money is being used to directly fund the profit margins of private investors.

However, the many individual components of a PPP structure, such as the construction of the facility, would have been provided by the private sector anyway. The marginal extra profit which the private sector makes from investing in a PPP project, as compared to the profits on conventional procurement, is probably not enough to sustain this argument.

Problem with financier-led PPP

A financial institution may devote substantial resources to putting together a consortium to make a bid, only to 'unbundle' the components as soon as the bid is successful. In these circumstances, it may be better for the government to contract directly with the private parties that ultimately bear the risk rather than contracting through a financial intermediary.

The government thus needs to be attentive to the composition of the private consortium and to the specific role of each player within the PPP contract to ensure long-term value for money.

Frequency of contract renegotiation

The advantage of PPP contracts for the public sector may be reduced as a result of renegotiation, which is becoming a more common feature of public-private partnerships, notably in South America. In those circumstances, the private party can bargain favorable contract terms that would have never been obtained under competitive conditions.

The public sector needs to be sure to protect the public interest by the same rigorous approach to renegotiation as that applied for the establishment and negotiation of the initial contract - Module 5 -> Renegotiations and Amendments to PPP Contracts.