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## **PUBLIC - PRIVATE PARTNERSHIPS**

### **Models and Trends in the European Union**

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## **Executive summary**

A public-private partnership (PPP) is a contractual agreement between the public and the private sectors, whereby the private operator commits to provide public services that have traditionally been supplied or financed by public institutions. The ultimate goal of PPPs is to obtain more “value for money” than traditional public procurement options would deliver. When correctly implemented, PPPs are said to produce reduced life-cycle costs, better risk allocation, faster implementation of public works and services, improved service quality and additional revenue streams.

From a theoretical view point, the main justification for the adoption of a Public-private partnership (PPP) is the possibility to exploit the management qualifications and the efficiency of the private sector without giving up quality standards of outputs, thanks to appropriate control mechanisms from the public party. To this end, the core principle of PPPs lies in the risk allocation between the two parties. A well designed PPP redistributes the risk to the party that is best suited to manage it and to do it with the least cost.

This briefing note provides an overview of the main models of PPP employed in the European Union, ranging from contractual schemes which provide for a marginal involvement of the private sector, to complex forms of PPP implying a greater allocation of risk and responsibility to the private party. As PPPs are commonly employed for the provision of various types of services, from road construction to education or healthcare facilities, the different models presented can be flexibly selected and tailored to the specific needs of the sector of application. In this respect, the correct evaluation of each party’s abilities and risk-management capacities is pivotal to ensure that the appropriate type of contract is selected and that both parties fully realise their potential.

Despite the absence of specific European legislation, the recent Green Paper on public-private partnerships launched a wide-ranging debate among Institutions and stakeholders, aimed at exploring the most challenging regulatory issues for PPPs in Europe. Some valuable insights on the recent developments and possible future trends in PPP implementation emerged during the consultation and are presented in this briefing note.

## 1 Introduction

A public-private partnership (PPP) is a contractual agreement between the public and the private sectors, whereby the private operator provides services that have traditionally been executed or financed by a public institution. The ultimate goal of PPPs is to obtain more “value for money” than traditional public procurement options would deliver. Although the *ex ante* assessment of expected value for money is often extremely complex, in general a PPP can be said to generate value improvements whenever it produces/achieves the following advantages:

- reduced life-cycle costs;
- more efficient allocation of risk;
- faster implementation;
- improved service quality; and
- additional revenue.

When compared with in-house delivery by the public sector, the private provision of a public service is socially beneficial whenever the net gains from PPPs are greater than the corresponding net gains from traditional public provision.<sup>1</sup> In a nutshell, the following relationship must hold true:

$$PPP \text{ net allocative efficiency gains} + PPP \text{ net productive efficiency gains} > \text{gains with public provision}$$

From a theoretical viewpoint, the main justification for the adoption of a PPP is the possibility to exploit the management qualifications and the efficiency of the private sector without giving up quality standards of outputs, thanks to appropriate control mechanisms from the public party. This result is achieved by setting up complex contractual arrangements with private sector operators where the public sector acts as “principal” and the private operator as “agent”. In principal-agent relationships, the most complex issues are the precise definition of the tasks assigned to the agent, the measurement of the agent’s performance, and the extent to which the principal can control and monitor the agent’s performance for the whole duration of the contractual relationship.<sup>2</sup> In PPPs, the core principle lies in the allocation of risk between the two parties: well designed PPPs redistribute the risk to the party that is the “superior insurer” or the “least cost avoider”, i.e. the party best suited to control and/or bear the risk.

Public-private partnerships are commonly employed for the provision of various types of services and infrastructure such as transportation (rail, metro, roads), energy, telecommunications, water treatment and supply, waste management, healthcare, criminal justice (courts and prisons), education facilities (schools, dormitories), and environmental management. PPPs generally take the form of a long-term (e.g. 30 years) agreement between public and private entities, whereby the private partner commits to perform some or most of the phases of the service or asset provision.

The complex and heterogeneous adoption of PPPs in European countries has led to the development of a considerable number of variants of this contractual arrangement. A comprehensive taxonomy is therefore complex to realize. This briefing note provides an overview of the existing PPP models within the European Union in the framework of the current legislation. Against this background, recent developments and possible future trends are presented.

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<sup>1</sup> Net gains are total benefits in terms of allocative and productive efficiency minus the total cost of delivery.

<sup>2</sup> See, e.g., J. E. Lane, *Public Principals and their Agents*, available at <http://www.spp.nus.edu.sg/docs/wp/wp32.pdf>, and, more in general, J.J. Laffont and D. Martimort, *The Theory of Incentives: The Principal-Agent Model*, Princeton: Princeton University Press, 2002.

## 2 General legal framework and some preliminary classification criteria

PPPs are not explicitly disciplined by European law, and are grounded on general EC Treaty principles as well as on secondary legislation. According to the general principles contained in the EC Treaty, all contracts whereby a public body awards a work involving an economic activity to a third party, whether covered by secondary legislation or not, are subject to the general principles on the freedom of establishment and the freedom to supply services. As a consequence, PPP contracts have to comply with requirements of transparency, equal treatment, proportionality and mutual recognition. Such guiding principles set a flexible framework for the development of various schemes of public-private cooperation and for different means of control by the public party.

Moreover, as far as secondary legislation is concerned, PPPs are indirectly disciplined by existing Directives on public procurement and concessions.<sup>3</sup> Thus, PPPs created for contracts that qualify as “public contracts” under the latter Directives must comply with their provisions. On the other hand, “works concessions” are covered only by a few provisions of secondary legislation and “service concessions” are not covered by the “public contracts” Directives at all.<sup>4</sup>

The 2004 Green Paper on public-private partnerships<sup>5</sup> provides further clarification on the implementation of PPPs according to EC secondary law on public procurement and concessions and establishes a first broad classification of existing agreements. According to the Green Paper, PPPs are divided into institutional PPPs and contractual PPPs. *Institutional PPPs* are characterized by the creation of an institutional entity jointly held by the public and the private operators. Such entity can be newly established or derive from the transfer of an existing structure from the public to the private party. *Contractual PPPs*, instead, are based on an agreement between the public sector and the private partner to provide a service in exchange for some form of compensation from final users or through regular payments by the public authority.

As recalled in the previous section, absent a clear-cut legal definition, the extent to which risk and responsibility are transferred from the public to the private party is at once the “litmus test” adopted to distinguish PPPs from other forms of public-private agreements, and the major criterion employed to classify different types of PPP. This criterion allows to define and classify each type of PPP in light of the applicable legislation and the methods used to select private parties.<sup>6</sup>

In this respect, the provision of services and assets entails the assumption of different categories of risk throughout the duration of the project. It is thus fundamental to understand the various types of risks and the way in which these can be allocated during the phases of a PPP project: this directly affects the means used by the public party to influence and control its private sector “agent”.

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<sup>3</sup> Directive 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors, OJ L 134 , 30/04/2004 p. 1-113; Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts, OJ L 134 , 30/04/2004 p. 114-240; Commission interpretative communication on concessions under Community law, OJ C 121 , 29/04/2000 p. 2-13.

<sup>4</sup> For further details, European Commission, Directorate-General Regional Policy, Resource book on PPP case studies, June 2004, p.12.

<sup>5</sup> European Commission, *Green Paper on public-private partnerships and Community law on public contracts and concessions*, Brussels, 30.4.2004, COM(2004) 327 final.

<sup>6</sup> European Commission, Directorate-General Regional Policy, *Guidelines for successful public-private partnerships*, January 2003, p. 19.

To this end, five main categories of risk can be identified:

- **Construction risk** is directly related to the design and construction phase, i.e. the risk of poor project definition, costs overruns, late delivery of the asset;
- **Financial risk** is linked to the variability of interest or exchange rates and to all factors that can influence the cost of financing a project;
- **Performance/availability risk** is related to the delivery/availability of the asset against contractual specification, i.e. the failure to meet quality standards or to ensure the continuity of service provision;
- **Demand risk** is linked to the actual need for the service, i.e. the risk that the overall demand for the service/asset concerned turns out being lower than initially expected;
- **Residual value** is related to the future market price of the asset; this type of risk is particularly relevant if property of the asset must be transferred back to the public entity at the end of the contract.

As already mentioned, “value for money” should be the ultimate goal of the public sector that chooses a PPP contract instead of a normal procurement procedure. When a PPP scheme is adopted, the public party has to face and solve principal-agent dilemmas to find the best way to create appropriate incentives for the (self-interested) private sector to deliver the desired outputs throughout the implementation of the contract. In short, this implies realigning the private incentives of the agent with the socially optimal incentives of the principal. From this standpoint, adopting a PPP approach always implies facing a trade-off between the efficiency gains achieved by involving the private sector and the output quality expected by the public party. Thus, the PPP option should be chosen only if the benefit-cost ratio of private provision outweighs the results obtainable with “traditional” government intervention. Hence, even greater costs will be acceptable, if overall net benefits justify the PPP solution. If a good balance is not achieved, this might result in higher costs and the inability of one or both parties to fully deliver the expected outcomes.

From the public party’s perspective, assessing whether PPP is the most suitable option to deliver a service is easier if some basic conditions are met. First, the government should be able to clearly identify the level of quality that the private party is bound to achieve in performing its contractual obligations. In addition, the public party should identify (*ex ante*) and use (*ex post*) appropriate output/outcome/performance indicators. This is generally easier when actions to be undertaken by the private party exhibit stable requirements over time; it is generally much harder to monitor contractual performance by the private agent whenever fast-paced technological progress or constantly changing market conditions dramatically alter parameters and quality indicators throughout the implementation of the PPP contract. For such reason, PPPs often happen to be more suited for road or railways construction than they are in the IT sector, where technological convergence makes the adoption of fixed and stable indicators particularly challenging.

When quality is non contractible and difficult to observe, the public party should not refrain from setting up effective means to ensure that the private operator actually delivers the expected output; otherwise, monitoring PPP implementation would only focus on achieved efficiency gains, with scant attention for the quality of service provision and, consequently, limited control on users’ satisfaction. For example, governments may reach their goals by linking the achievement of operational quality targets with the choices made by the private party during the infrastructure building phase. This way, the private party, instead of focusing mainly on cost savings while building the assets, will have to take into account the public party’s request already during the construction phase, to avoid incurring sanctions and higher costs caused by a poorly constructed asset.

### 3 Models of public-private partnerships in the European Union

This section contains a short overview of the main types of PPP ranging from the least sophisticated modes of private sector involvement to the most complex forms of PPP implying greater risk transfers from the public to the private party.<sup>7</sup> The main models listed by the European Commission are illustrated below.

- **Service contracts** are agreements between a public agency and the private sector particularly suited for simple, short-term operational requirements. It is a very limited form of PPP, where the private party procures, operates and maintains an asset for a short period of time. Management and investment responsibilities remain with the public sector, which bears the financial risk and residual value risk, but benefits from the technical expertise of the private operator and obtains some cost savings, without transferring control over the quality of outputs. Service contracts are commonly used for toll collection services, for the provision and maintenance of vehicles or other technical activities.
- **Operation and management contracts** are agreements in which the responsibility for asset operation and management is passed on to the private sector. The duration is generally short but can normally be extended. The private party is remunerated on a fixed fee basis or on an incentive basis with premiums linked to specific performance targets. The public party still bears the investment risk and the financial risk. This type of contract allows significant efficiency gains and investment in technological sophistication, as the private operator has a strong interest in improving service quality to reduce both overall costs and the demand risk during the operational stage. This type of agreement is particularly suited during transition phases that ultimately lead to privatisation. It can also be used to stimulate greater private participation in service delivery by setting the conditions for a greater involvement of the private sector in a secondary stage.
- In **Leasing** agreements, the private party purchases the income streams generated by publicly owned assets in exchange for a fixed lease payment and the obligation to operate and maintain the asset. Since the commercial risk and the demand risk are transferred to the private sector, the private agent has an incentive to achieve operational efficiency. The private party indeed profits only if it manages to reduce operating costs while meeting the designated service level. On the other hand, the public party bears the risks related to network expansion (construction), capital improvements and financing. Leasing is particularly suited for infrastructures that generate independent revenue streams, as occurs in the case of public transport. More complex leasing schemes such as the BBO, LDO or WAA (see table below) allocate greater construction risk to the private sector, thus reducing the burden for the public party.
- **Turnkey procurement or Build-Operate-Transfer (BOT)** is an integrated type of partnership in which the private party bears the responsibility of designing, constructing and operating the asset. The combination of these different responsibilities under a single entity fosters greater efficiency gains and removes important maintenance issues from the public budget. This integrated scheme obliges the private operator to take into account the cost of operating the asset during the design and operation phase and therefore stimulates a better planning and management of the service itself. Here again, the public party bears the financial risk; however, unlike what occurs in other types of PPP, the public party relinquishes its control on important phases of the life-cycle of the asset. Since the ownership of the asset generally remains with the public party, the specification of quality outputs is essential for achieving the desired results.

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<sup>7</sup> European Commission, Directorate General for Regional Policy, *Guidelines for Successful Public-Private Partnerships*, January 2003, p. 20.



The BOT scheme is considered to be particularly suited for water and waste projects, and can be declined in a number of variants (BOOT, BROT, BLOT, and BTO) according to the specific project needs.

- **In Design-Build Finance-Operate (DBFO) schemes**, the private partner designs the service or the asset according to the requirements set by the public entity, ensures and finances the construction/implementation of the asset/service following the design phase, and finally operates the facility. At the end of the PPP contract, the service or asset can be granted back to the public sector under the terms of the original PPP agreement; in alternative, the agreement is renegotiated. DBFO is the most complex type of PPP, since it guarantees all the implementation and operational efficiencies of the previous models, but also provides for new sources of capital. The most common model is the **DBFO concession** where the private investor designs, finances, constructs and operates a revenue-generating infrastructure in exchange for the right to collect the revenues for a specified period of time, generally for 25-30 years. Ownership of the asset remains with the public sector. This model is particularly suited for roads, water and waste projects and generally for services where user charges can be applied. To the contrary, in a variant termed **private divestiture**, the asset is partially or entirely sold to the private sector, while the government only maintains a regulatory role aimed at protecting consumers from monopolistic prices and output restrictions. The divestiture can also be partial, if the government maintains the ownership of some portion of the asset to ensure a certain standard of service while transferring a substantial share of overall costs to the private partner. The DBFO model can be declined and adapted in multiple ways to respond to the peculiarities of the service provided.

The following table summarises the different PPP schemes and their main variants according to the modalities and characteristics presented so far<sup>8</sup>.

Schemes	Modalities
<b>Service contracts</b>	<i>The private party procures, operates and maintains an asset for a short period of time. The public sector bears financial and management risks</i>
<b>Operation and management contracts</b>	<i>The private sector operates and manages a public owned asset. Revenues for the private party are linked to performance targets. The public sector bears financial and investment risks</i>
<b>Leasing-type contracts</b> <ul style="list-style-type: none"> <li>○ Buy-build-operate (BBO)</li> <li>○ Lease-develop-operate (LDO)</li> <li>○ Wrap-around addition (WAA)</li> </ul>	<i>The private sector buys or leases an existing asset from the government, renovates, modernizes, and/or expands it, and then operates the asset, again with no obligation to transfer ownership back to the government</i>
<b>Build-operate-transfer (BOT)</b> <ul style="list-style-type: none"> <li>○ Build-own-operate-transfer (BOOT)</li> <li>○ Build-rent-own-transfer (BROT)</li> <li>○ Build-lease-operate-transfer (BLOT)</li> <li>○ Build-transfer-operate (BTO)</li> </ul>	<i>The private sector designs and builds an asset, operates it, and then transfers it to the government when the operating contract ends, or at some other pre-specified time. The private partner may subsequently rent or lease the asset from the government.</i>
<b>Design-Build-Finance-Operate (DBFO)</b> <ul style="list-style-type: none"> <li>○ Build-own-operate (BOO)</li> <li>○ Build-develop-operate (BDO)</li> <li>○ Design-construct-manage-finance (DCMF)</li> </ul>	<i>The private sector designs, builds, owns, develops, operates and manages an asset with no obligation to transfer ownership to the government. These are variants of design-build-finance-operate (DBFO) schemes.</i>

**Source: Elaboration on IMF (2004) and European Commission (2003)**

The different PPP models presented above can be flexibly selected and tailored according to the sector of application. Some areas are better suited for risk transfer to the private party than others, as the different models imply various degrees of control by the public party.

<sup>8</sup> See also International Monetary Fund, *Public-Private Partnerships*, March 12, 2004, p.8.

In general, the private sector proved to be a better manager of construction risk and quality standard risk, while regulatory risk is more appropriately borne by the public sector. Correct evaluation of each party's abilities and management capacities has a direct impact on the choice of the PPP model and on the likelihood of success or failure of the project. Below, we provide two examples which highlight the importance of carefully designing the contractual arrangement and assessing the party's relative strengths and weaknesses as a key driver for PPP success.

#### **Example 1: Wijkertunnel Randstad, The Netherlands**

This project was launched in 1991 to reduce traffic congestion and car accidents by constructing a tunnel in the densely populated area of the Randstad. The chosen contract agreement is a 30-year BOT Concession between the National Transportation Department and the ING Bank. During the tender procedure, the latter was the only bidder, which raised some concerns on the outcome of the tender process and the appropriateness of the selected party.

In this PPP, the private party (ING) bears design and construction risks. A shadow toll system sets the minimum revenue on a financial/traffic demand base, while the maximum revenue is not capped but related directly to actual usage. As the demand risk remained with the public party, costs to the State rose dramatically, since maximum revenues had not been capped. In the end, the PPP turned out to be more expensive than the public intervention alternative.

This example demonstrates that poor tendering and structuring of a PPP project might create insurmountable problems for the whole duration of the contract, particularly when the PPP allocates little or no demand risk to the private party. Lack of sufficient understanding of PPPs and of a robust assessment of the project's value for money created a significant financial burden for the State that could have been avoided through a better tendering and evaluation of the PPP contract itself.

#### **Example 2: Dublin Region Waste Water Scheme, Ireland**

The Dublin region waste water scheme was launched within the Water Services Investment Programme 2000-2006 to attract the best technology and expertise available in the market and to increase economic and environmental efficiency in treating waste water produced by domestic and commercial consumers.

The PPP scheme is set up as a DBO contract between the Dublin Municipality, the Water Authority and a Private International Consortium. The risk is mostly allocated to the private party that bears maintenance and operation costs, while the public party provides financing and retains the ownership of the asset. The contractor is paid through tariffs levied on non-domestic consumers. The tariff level is set at a sufficient level to cover both capital and operating costs. The private party is contractually bound to maintain the treatment plant and to cover its operating costs for 20 years. As a consequence, to obtain some profit, the private party has an incentive to increase efficiency by reducing both operating and maintenance costs.

This balanced PPP agreement is a valuable example of how the public sector can manage to attract the latest available technology while protecting capital investment and ensuring sustainability of a project in the long run.

## 4 Recent developments and trends in European public-private partnerships

The Commission's 2003 Green Paper launched a wide-ranging debate aimed at exploring the most significant regulatory issues for PPPs in Europe. By addressing a variety of topics stemming from the selection procedures of the private partner to contractual details, the Green Paper provides valuable insights on the recent developments in European PPP schemes. A closer look at some of the aspects of the PPP models presented above helps in identifying possible future trends and their potential impact on the public party's means of control and influence during the different stages of PPP implementation. We distinguish between problems that may arise during the tendering phase, the design/building/financing phase, during the operational phase and during renegotiation phases.

### 4.1 The tendering phase

The best way to ensure that output quality is at least comparable with what would be expected in case of in-house public provision is to clearly set out quality standards and indicators during the tender procedure, so that the private party is aware of such contractual requirements when submitting the offer. A precise definition of quality standards is also crucial for avoiding the so-called "adverse selection problem". Adverse selection occurs when the public party (the principal) is not able to observe the quality of the agent's performance and therefore chooses contractual conditions that will attract only low quality bidders in the tender.<sup>9</sup> Well-crafted tender requirements facilitate this task: in this respect, public parties can generally rely on extensive experience developed through traditional public procurement contracts.

When the *ex ante* specification of applicable quality standards is not a feasible option, *e.g.* because of the peculiarities of the service/asset at hand, the so-called *competitive dialogue* procedure may represent a viable and manageable alternative for the public sector. For this reason, as the recent Green Paper consultation demonstrates, its importance is on the increase, in particular for highly complex public contracts, where the public party does not have predefined standards/options on how to deliver the service. In a competitive dialogue process, bidders are invited to propose their own solution during a competition. This guarantees that the public party collects creative and innovative approaches, and preserves greater independence in choosing how to structure and award the final tender and how to define expected output characteristics.

The competitive dialogue procedure was explicitly introduced with the Directive 2004/18/EC, but has not been implemented in all member states to date. To be sure, further refinements are needed to enable an efficient and effective implementation of this promising method. The concerns raised by private operators are mostly related to the level of competition ensured during the dialogue process, and to the respect of intellectual property rights. From what concerns IPRs, it is crucial that the public party makes an appropriate use of the information and innovative solutions proposed: as the tender is awarded to the most preferred bids, the awarding entity must commit to refrain from disclosing the content of the offers received, otherwise bidders will have scant incentives to provide valuable and original hints during the competitive dialogue phase. The most crucial issue in competitive dialogues is solving the trade-off between the bidder's incentive to disclose *ex ante* detailed information needed to win the tender, and the risk that some elements of the final contract *ex post* are based on an idea provided by a losing bidder.

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<sup>9</sup> See G. A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, Quarterly Journal of Economics, 84(3), pp. 488-500, 1970. For an application to public procurement, see also D. Parker and K. Hartley, *Transaction Costs, Relational Contracting And Public-Private Partnerships: A Case Study of UK Defence*, Journal of Purchasing and Supply Management, 9, 2003, 97-108.

For such reasons, competitive dialogues often entail significantly longer and more costly negotiations than traditional public procurement, and do not provide the public sector with a valuable tool to control and guarantee the overall quality of the asset/service design, unless the impact on private partners is carefully assessed and managed during both the competitive and the post-award stages. In this respect, the Commission plans to issue an explanatory document to dissipate concerns about the application of the competitive dialogue procedure.

#### 4.2 *The building and financing phase*

The building phase is generally the least prone to risks if overall costs have been calculated correctly at the outset. Available empirical evidence shows that PPPs generally lead to a timely delivery of the requested service/asset. Accordingly, the main risk faced by the public sector is that actual costs exceed the forecast, forcing the public party to pay for the difference in order for the asset/service to see the light. So far, reliance on previous experience in the field of public procurement contracts and use of accurate output indicators are the only two operational means of control for the public entity in the building stage of any PPP contract.

To the contrary, financing arrangements are one of the most debated and critical issues of PPPs, in particular since the cost of financing is generally much higher for the private than for the public sector. This increases the likelihood that a project's risk is calculated correctly, which might not be the case when the public sector is the only party bearing the financial risks. Based on the assumption that "government will always pay", some inefficient projects have been approved in the past. For this reason, projects that allocate the financial risk to the private party are likely to be evaluated more precisely and realistically. But in this case, financial institutions/lenders might engage in overly conservative forecasts, thus overestimating risk and raising the overall cost of the project for the private party. In that case, the PPP value for money relationship presented in the introduction of this briefing note would appear not to hold anymore, leading public authorities to discard PPP projects that would have been the best option for the delivery of a specific service.

Proper financial arrangements are extremely relevant to the public party, as any miscalculation will directly impact on public accounts. Nevertheless, meticulous financial evaluation of the risks related to private financing in the provision of public assets should not hamper the adoption and diffusion of PPP schemes for fear of a backlash on public finances. To this end, a new instrument, called *credit guarantee finance*, has been designed to reap the benefits of the joint involvement of the public and private sectors in public assets delivery. Through the credit guarantee finance, the government borrows and then lends to the private party with a guarantee of the loan coming from a private financier that takes on the risk. This allows a reduction of the overall cost of financing the private sector, while at the same time maintaining the financial risk away from the public party. So far, credit guarantee finance is being tested mainly in the United Kingdom. If results will be encouraging, this instrument could set a new trend in PPPs, fostering their expansion in sectors where access to finance for PPP projects has proven difficult so far.

### 4.3 *The operational phase*

The operational phase is normally the one in which the public party is most marginally involved. The different PPP options presented in Section 3 show that the greater the risk allocated to the private party, the smaller is the public involvement in the operational phase of the contract. This does not mean, however, that public control on project implementation necessarily decreases, as in the operational phase the public entity can use output/outcome indicators to monitor the private agent's performance.

To the contrary, exerting some degree of control on the behaviour of the private party during the operational phase is essential for the public party, as it significantly reduces the risk of "moral hazard".<sup>10</sup> If service provision is linked to some form of payment or premium, these means of control constitute indirect forms of involvement of the public party in the operational phase, mostly through incentive schemes imposed on private parties.

### 4.4 *The renegotiation phase*

As the first PPP agreements concluded in some EU member states are now about to expire, it is worth dedicating some attention to the issue of renegotiation clauses in PPP contracts. Renegotiation is a way for the public sector to reaffirm its control on the modalities of service provision by adapting the contract characteristics to new developments that were not foreseen or taken into account from the beginning of the PPP arrangement. Furthermore, renegotiations can be used to reallocate wrongly distributed risks to the party that is best suited to bear them.

It is of utmost importance to distinguish between contractually scheduled renegotiations and (early) unforeseen renegotiations that are initiated at the request of the private party. For example, early renegotiation sometimes takes place when the private operator realises, during the operational phase, that it is not able to abide to the terms of the contract and/or needs more financing. A particular case occurs when the private party initially overestimates the potential demand and later attempts to renegotiate the agreement, so that the public party is obliged to bear the costs related to demand risk to avoid the complete failure of the PPP.<sup>11</sup> In those circumstances, the private party can bargain favourable contract terms that would have never been obtained under competitive conditions. The absence of other competitors during early renegotiation phases significantly weakens the public party's bargaining position, and in turn reduces the chances to achieve real value for money from the PPP agreement at stake.

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<sup>10</sup> Like adverse selection, moral hazard is a case of market failure, which occurs whenever a principal is not able to observe its agent's conduct, and accordingly cannot link the final remuneration of the agent on the basis of the latter's behaviour. When this happens, the agent has an incentive to behave inefficiently, and focuses exclusively on reducing its costs, to the detriment of overall quality of supply.

<sup>11</sup> See the Hungarian case in *companion briefing note Public - Private Partnerships. National Experiences in the European Union*.

#### 4.5 *In which sectors are PPPs a valid option?*

So far, PPPs have been successfully employed to provide road and railway infrastructure, waste and water management, healthcare and school buildings. Possible trends in European PPPs are related to their potential expansion to different sectors. However, it remains to be seen if PPPs are really capable of ensuring value for money in areas closely linked to the core competences of the public sector, such as clinical services, education or prison facilities. In this respect, European member states have widely differing approaches to PPP schemes, with some very active countries like the United Kingdom and France and others lagging behind such as Belgium, Finland and Greece.<sup>12</sup> The future expansion of PPP arrangements will mainly depend on the success or failure of existing pioneer projects and on the political will and support expressed at national level for this type of scheme.

Nevertheless, some preliminary conclusions can already be drawn. As the principal agent theory suggests, PPPs can be successfully applied only to those sectors where service quality can be clearly specified, measured and guaranteed. This is particularly complex to achieve in those areas, such as healthcare and education, where public-interest objectives generally clash with the cost-saving behaviour of the private party, thus resulting in complex and costly contractual negotiations. After all, available empirical evidence reveals that like the road to hell, also the road to welfare decreasing public services is often full of good intentions.

*Ex-ante* cost savings may result in *ex-post* cost increases, either because public goals are not achieved, or because attempts to better specify, measure, and guarantee service quality incur high transaction and administration costs.<sup>13</sup> Anecdotal evidence about British hospitals seems to confirm this preliminary assessment.<sup>14</sup>

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<sup>12</sup> For further details see companion briefing note, *supra*.

<sup>13</sup> Armin Riess, *Is the PPP model applicable across sectors?*, EIB papers, 2005, Vol. 10. n.2, p.28.

<sup>14</sup> *Private finance for public schemes may run out of road*, the Financial Times, February 7, 2005. Article available at <http://news.ft.com/cms/s/1918b472-9815-11da-816b-0000779e2340.html>

## 5 Conclusion

Some member states are increasingly adopting PPPs as an alternative to the traditional in-house provision/procurement of public services. In most advanced national experiences, new forms of PPPs are continuously emerging, and the existing ones are being tailored to the needs of different sectors.

In line with the broad classification offered by this briefing note, what emerges from the observation of currently adopted schemes is that each PPP arrangement should be designed and adapted to the specific characteristics of the asset at stake, as well as to the peculiar abilities of all partners involved in the project. In order to guarantee value for money, the relative strengths and weaknesses of each PPP scheme should be considered. Depending on the sector of application, some models are better suited than others in delivering targeted outputs and in ensuring accurate risk management. Choosing the wrong model or inaccurately evaluating the risk management capacities of each party may have extremely costly consequences and a negative impact on public accounts, as the example of the Wijkertunnel Randstad clearly shows.

Moreover, EU member states have different needs and priorities when it comes to delivering public infrastructure and services. In this respect, existing European legislation is relatively flexible and the absence of specific provisions guarantees that a wide variety of approaches can be adopted at national level. The results of the consultation launched by the Green Paper shed some light on the possible future direction of European regulation in this field. Clarification on renegotiation issues and on the competitive dialogue procedure will undoubtedly facilitate the emergence of new models, trends and innovative solutions for setting up efficient PPPs.

Finally, it is worth pointing out that PPPs are not always the best option, even if the benefits of private involvement in public assets provision are self-evident in many cases. PPP relationships are difficult to design, implement and operate. In a word, the risk of remaining locked-in an inefficiently designed contractual arrangement is high. As a result, the *ex ante* assessment of value for money and the evaluation of overall expected allocative and efficiency gains should always play a pivotal role both when choosing a PPP approach and when deciding which of the available models is best suited for the case at hand.

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