PUBLIC PRIVATE PARTNERSHIPS
WHO BEARS THE COST?

> *Free lunches are notoriously scarce in economics. If, say, a road is built, and the government pays a developer an annual lease fee, it is still money. The money has to cover the developers' cost of capital as well as other costs, and is not really different to paying interest on a government loan.*
>
> *All other things being equal the government should be able to borrow at a more advantageous rate than a private consortium, so from a fiscal point of view the fee is likely to be higher than the debt servicing costs. The loan doesn't show up on the government's balance sheet, but this is probably not all that material.*
>
> Michael Cullen 12 November 2002
> to the National Press Club/British Trade Council

In the traditional model of infrastructure development; a model which gave our communities the foundations upon which the fabric of our society grew; our government bodies at various levels planned, designed, approved, financed, built, owned, operated and maintained all the essentials of life. There appeared to be no limit to their purview – hospitals, fire services, telephone exchanges, postal services, roads, rail services, ports, airports, airlines, shipping lines, water, wastewater, electricity, police, defence and telecommunications, and all the bureaucracy needed to administer them, and to assure the public that the services they provided would continue to be available.

All these services were invariably financed by public debt, with repayment secured variously through the central government's ability to tax, local government's ability to levy rates and user charges. Good security for a lender that the debt would be repaid.

So why look at alternatives?

In the UK, and to an extent in Australia, among the justifications for the proliferation of PPP projects (and PFI projects before them) was to keep the debt which would otherwise be associated with the project *off balance sheet*. As Dr Cullen also observes, this is probably not all that material. Some commentators have already pointed out that if the government is underwriting the private sector's return, the asset and the debt associated with it should almost certainly appear on the government's books as it is little more than a finance lease. In New Zealand, it is unlikely that such considerations will be relevant.

The answer almost certainly lies in the answer to Dr Cullen's other question – if governments can borrow more cheaply than the private sector, what does private sector involvement offer that the government cannot. This will vary from project to project, but in most cases it is the efficiency which the private sector can bring, whether through innovation, improved allocation and management of risk or avoidance of some other

constraint, which makes these projects attractive. The savings arise less through funding cost than through timely completion and efficient operation.

All parties to PPP projects will be expecting to recover their costs, and make a return on their investment. For the relevant government body, it will be expecting the provision of a public service which is better and more cost effective and reliable than had it developed, financed and operated the service itself.

Taking the roading example, the private sector will recover its costs in a number of ways, each of which will reflect different levels of public sponsorship:

- some level of central government funding or support (for example, through Transfund),
- regional government subsidy where there is a passenger transport element (for example, through the provision of a busway),
- territorial local authority sponsorship (through provision of consents, properly rights, capital contribution or shadow tolls), and
- user charges (through the levying of tolls or similar).

To varying degrees, recovery will have fixed and variable elements, and may be put at risk depending on patronage and performance. It is extremely unlikely that a private sector joint venture would accept all its costs being at risk on toll revenue, or performance adjustment.

The community will pay for their new asset at all levels - nationally, regionally, locally and by use. When compared to the traditional model for roading, the significant difference is the addition of the last method of recovery; by use. Unlike the Auckland Harbour and Tauranga bridges where tolls were used to recover the cost of construction, in typical PPP projects you would expect a further concession would be granted following an appropriate bidding process on the expiry of the initial concession, and the tolls continued, thus freeing up capital for further infrastructure developments.

Whatever the financing source, the national, regional and local communities will pay for their new asset and will provide a return to the private sector.

The government body promoting the project; in most cases a territorial local authority; has as its primary focus, the delivery of the public service to a quality, at a cost and for the duration contracted. Extensive performance indicators, each with appropriate incentives, penalties and step-in rights, will be required. The entire community will pay for the asset to some degree or other throughout the life of the concession. If the private sector operator fails, that cost may become significantly greater and may need to be paid sooner than any one anticipated, but the public sector will still bear that cost.

As Dr Cullen observes, *free lunches are notoriously scarce*. But if the reasons for doing a PPP project are carefully articulated and risks allocated appropriately, the lunch may be very good value for money.

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