PPP/PFI

Strange Acronyms?
or a Sensible Alternative to Infrastructure Development

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Introduction

With BOOT (build own operate transfer), BOO (build own operate), BOT (build operate transfer), DBFO (design build finance operate), BTO (build transfer operate) and other permutations, we now have the more generic PFI (private finance initiative) and PPP (public private partnership) to contend with.

Behind this proliferation of acronyms there is a useful and interesting trend developing, mostly lead from the United Kingdom, which has caught the public eye.

Public Private Partnerships (PPP)

In most seminars and writings on the subject, a bewildering maze of flowcharts is presented, showing how large and complex the relationships are (and by extension the documentation required). The consistent thread in each approach, however, regardless of the initials used, is the appointment of the private sector to develop, and usually own, assets traditionally held in the public domain. This has developed over the last 10 years or so to include the provision of the services themselves.

Under the UK model, typically the private sector contracts with the public sector to provide at its own cost:

- All necessary assets (whether a new prison, hospital, school or road)
- Staff for operation and maintenance of the service
- The provision of the service to agreed levels

This may include the transfer of an existing asset from the government body to the private sector, the grant of associated rights and for the private sector to fund the acquisition, development and operation entirely at its own cost. Generally, the term of the appointment is in the region of 30 years, and if the funding is available, more.

The funding cost is then covered either directly by users (eg through tolls or other use based charges) or by the public sector itself (eg through shadow tolls). Some form of guarantee for cashflow purposes is also typically given by the public sector.

Why PPP

Over the last 10 years or so, under the broad heading of PFI/PPP, more than 450 projects have been let in the United Kingdom, representing over £20 billion in investment.

The views on the success of PFI/PPP in the UK are mixed. On the plus side:

- Private sector efficiencies have been delivered (principally in the cost of providing the services)
- Service levels have been maintained or improved, depending on the industry
- Good returns have been provided for investors

On the negative:

- Concluding the early transactions was time consuming and difficult, with perceptions that the only beneficiaries were the lawyers and investment bankers who negotiated the deals
- PR for the early projects were not good, with a perception that service levels were not being improved, assets not maintained and the private sector was making a runaway return (one project resulted in a 39% return, with only 5% equity commitment)
- The experience of rail, with the separation of track from operations and the perceived difficulties with the London Underground project, have not been shining examples of the private model

Ultimately, whether fuelled by an enduring belief that the private sector can deliver efficiencies that the public sector cannot or by the strength of the construction industry being such that it can promote such projects itself, the model has enjoyed significant success in the UK. Through standardisation of contracts, deal costs and delays have been reduced to the extent that the model is now being used for more modest projects which can deliver real return to the community.

A substantial capital market has developed with an appetite for long term debt (some bonds exceeding 35 years) and the perception that unjustified returns are being made has been addressed by providing for a sharing mechanism on savings in funding costs (effectively more risk sharing).

Drivers for the success in the UK were:

- A belief (at time during the Thatcher years bordering on doctrinaire) that those in the private sector are better managers than their equivalents in the public sector
- Constraints on central and local government spending, making “off balance sheet” developments more attractive
- Available capital, principally through contractors
- A strong capital market, with a significant appetite for long term investment

PPP Elsewhere

Similar privately funded infrastructure approaches have been looked at in Germany (hire-purchase, lease and renting projects) and elsewhere in Europe, Japan and in Australia. BOT projects have been the mainstay of tunnel, bridge and roading construction and operation in Hong Kong, and are seen as a source of capital for other Asian nations which were once seen as developing.

In Australia, private funding has been used to restructure existing assets and for the development of new assets. In Victoria, the success of the privatisation programme has encouraged the State Government to develop a policy framework called *Partnership Victoria* to assist with and promote infrastructure development.

In New Zealand, PFI/PPP models were considered for Wellington and Auckland hospital redevelopments, but abandoned. There is a growing acceptance, however, of the benefits of contracting out asset management functions at local government level, and that public services do not necessarily need to be provided from publicly owned assets, though there is a lingering concern about service levels.

Similarly, while we do not currently enjoy access to the long term capital markets which have established in the UK, there is interest in New Zealand in long term, gilt edged funding which projects like these can provide, particularly when backed by appropriate guarantees. Some privately funded developments have been completed here (eg the Wellington and Hutt Valley waste water treatment projects and the Mokai geothermal project), and there is growing interest.

The form of any large scale PPP developments here is likely to be determined by need. In contrast to the UK:

- We do not have the constraints on borrowing which have held back local government in the UK (though legislative change will be required in some industries)
- Generally traditional debt equity is available to local authorities (typically through LATES) more cheaply than would be available through the more complex approach taken by PPPs
- Our contractors are characterised by poor capitalisation compared to Europe, Australia and the US, though alternative sources of equity would almost certainly be found

There is a real need, however, for infrastructure development in New Zealand, and we have the benefit of considerable work in the UK and Australia. Presented as an opportunity to develop assets which would otherwise not be available, public reluctance to pay tolls and other user charges may fade; particularly if the assets are seen as held locally through investment funds.

The drivers here are likely to be:

- Need for the development of new infrastructure due to initially poorly developed assets and lack of proper maintenance and provision for growth
- Public desire for first world infrastructure development

- Lack of government will to develop the assets through traditional debt (appetite for increased taxes is limited, and concern over inflationary pressures means that budget deficits are things of the past)
- Shortage of local capital, and concerns over foreign ownership
- Public wariness over perceived asset sales without real long term benefit
- Increased desire to see the concept of "service" returned to the public sector, rather than hard nose private sector commercial drivers

In this context, our version of the PPP model will be an interesting departure from those followed elsewhere. We can, however, certainly benefit from their experiences.