

PUBLIC PRIVATE PARTNERSHIPS: OPTIONS FOR IMPROVED RISK ALLOCATION

JOHN QUIGGIN*

I INTRODUCTION

Problems associated with inadequate investment in physical and social infrastructure have received a good deal of attention recently, along with skill shortages that have been attributed to inadequate investment in human and social capital. Areas of particular concern have included transport infrastructure (notably ports and urban rail), electricity and water supply systems, and social infrastructure such as health facilities.

Public private partnerships ('PPPs') have been widely adopted in Australia, primarily because they are seen as a source of additional funds for infrastructure investment. The idea that PPPs increase the amount available for investment in infrastructure has been regularly refuted by economic analysis¹ and disclaimed by government officials responsible for PPP programs.² Unfortunately, it has just as regularly been revived by politicians and financiers promoting increased reliance on PPPs.³

Nevertheless, official statements in support of PPPs now rely primarily on the claim that they are seen as providing better value for money than alternative modes of procurement, essentially because of superior risk allocation, and the

* Australian Research Council Federation Fellow, School of Economics and School of Political Science and International Studies, University of Queensland. I thank Nancy Wallace for her helpful comments and criticism. This research was supported by an Australian Research Council Federation Fellowship.

1 Economic Planning and Advisory Commission, Commonwealth, *Private Infrastructure Task Force: Interim Report* (1995); Economic Planning Advisory Commission, Commonwealth, *Private Infrastructure Task Force: Final Report* (1995); Standing Committee on Communications Transport and Microeconomic Reform, Parliament of Australia, *Planning Not Patching: An Inquiry into Federal Road Funding* (1997) <<http://www.aph.gov.au/house/committee/cita/roading/contents.htm>> at 10 September 2006.

2 Ian Little and John Pierce, 'Private Provision of Public Infrastructure and Services' (Speech delivered at the Australian Council for Infrastructure Development Luncheon, Sydney, 5 April 2002 and Melbourne 12 April 2002) <[http://www.partnerships.vic.gov.au/CA25708500035EB6/WebObj/PPP_AusCIDPresentationApril2002/\\$File/PPP_AusCIDPresentationApril2002.pdf#search=%22Ian%20Little%20and%20John%20Pierce%2C%20%E2%80%98Private%20Provision%20of%20Public%20Infrastructure%20and%20Services%22%22](http://www.partnerships.vic.gov.au/CA25708500035EB6/WebObj/PPP_AusCIDPresentationApril2002/$File/PPP_AusCIDPresentationApril2002.pdf#search=%22Ian%20Little%20and%20John%20Pierce%2C%20%E2%80%98Private%20Provision%20of%20Public%20Infrastructure%20and%20Services%22%22)> at 10 September 2006.

3 John Quiggin, 'Public-Private Partnerships: Options for Improved Risk Allocation' (2005) 38 *Australian Economic Review* 445.

benefits to be derived from cooperative partnership relationships. Hence, it is claimed, higher quality services may be delivered at a lower cost through PPPs than through alternative modes where the public sector retains ownership of core assets such as roads, schools and hospitals, while contracting with the private sector for construction and for a range of associated services. In this paper, these claims will be critically scrutinised.

II PARTNERSHIP

The term ‘public private partnership’ may be regarded as a ‘persuasive definition’, since it draws on the positive connotations of the term ‘partnership’.⁴ The provision of public services inevitably involves interaction with private sector partners, whether as suppliers, contractors or joint venturers. It is important, therefore, to consider what kind of relationship is involved in a PPP and whether it achieves the benefits typically associated with a partnership.

A partnership is a relationship between specific parties, who can normally be assumed to operate on shared understandings of mutual benefit, rather than relying primarily on written contracts. Such a relationship has important benefits for risk allocation, since it implies a commitment to deal with unforeseen contingencies cooperatively, rather than seeking to rely on rigorous interpretation of contractual terms. On the other hand, partnerships have the disadvantage of being inflexible, since parties cannot normally dispose of their interest without the consent of their fellow partners.

Examination of the record of PPPs, notably the recent controversy over the Sydney Cross City Tunnel, suggests that the relationship is asymmetric, and that the term ‘partnership’ does not accurately describe the position of private parties. The assets, income streams and obligations on the private side of the deal are tradeable and actively traded assets. As a last resort, private parties can simply walk away from unfavourable contracts, writing-off the associated investment in what is, typically, a subsidiary or joint venture. This occurred with the public transport contracts written by the Kennett Government in Victoria.

In contrast, the public party has little or no ability to walk away from the deal. With a long-term contract of the kind usual in PPP arrangements (commonly from 10 to 25 years or more), the government loses any capacity to alter the contract terms to meet changing needs and circumstances, except insofar as these can be negotiated with the private partner. Moreover, while the government forgoes any competitive benefit that might arise from the entry of new competitors, the private party can capture these benefits through subcontracting or the sale of assets. Thus, PPPs present the public party with most of the costs of a partnership, but few of the risk allocation benefits. If the rhetoric of partnership is to be made meaningful, the commitment of both parties to cooperative behaviour must be built into the original structure of the relationship.

4 Poole refers to terms of this kind as ‘unspeak’, since they embody unspoken arguments in a way that implicitly precludes contract: Steven Poole, *Unspeak* (2006) 3–4.

These problems are particularly severe in relation to contracts involving service delivery, such as PPP projects for schools and hospitals. In the absence of PPP funding, the special-purpose facilities involved in such projects would normally be owned by the public sector, and contracts with the private sector for ancillary services would typically run for periods of less than five years. The difficulties are illustrated by the case of the Port Macquarie Hospital in New South Wales, a PPP arrangement that ended in failure. Since the Government could not simply withdraw from the provision of hospital services in the area, it was forced to buy the hospital back from the private sector. As a result, in the words of Premier Morris Iemma, the project was 'paid for twice over by the taxpayer'.⁵ A similar failure occurred at the Robina Hospital in Queensland.

III RISK ALLOCATION

The allocation of risk is the central issue in contracting. Partnerships Victoria's policy statement on PPPs sets out the optimality principle governing risk transfers: '[t]he principle governing risk transfer is that risk will be allocated to whoever is best able to manage it at least cost, taking into account public interest considerations'.⁶

In practice, however, risk allocation in PPPs has been influenced, to a large extent, by presentational and accounting considerations unrelated to the principle of optimal allocation.

In presentational terms, governments have found it politically advantageous to bundle all contractual relationships into a single contract. This makes the contract less transparent and increases some risks faced by government, such as those associated with renegotiation, while passing other risks to the financiers who put together the consortium required for this kind of bundling.

Public accounting rules require transfer of income risk if the stream of obligations in the contract is to be classed as an operating lease, which is not recorded as debt in the public accounts, rather than a finance lease, which is treated as debt. There is a strong political incentive to achieve the required transfer. The result, in general, is that too much risk is transferred and opportunities to unbundle risks are foregone.

The biggest problem arises with the transfer of demand risk. In most situations considered for PPP contracts, the public sector partner is best able to manage risk, particularly where public interest issues arise. The most obvious case is that of urban road projects. Each urban road project constitutes a single element embedded in an existing publicly-owned road network, where demand is conditioned by factors such as fuel taxes, provision of public transport and urban development policy. All of these factors are under the direct or ultimate control of the public partner. By contrast, the factors under the control of the private

5 ABC Television, 'Abbott Pushes for Private Management of Public Hospitals', *Lateline*, 12 September 2006 <<http://www.abc.net.au/lateline/content/2006/s1739519.htm>> at 10 September 2006.

6 Department of Treasury and Finance, Victoria, *Partnerships Victoria* (2000) *Partnerships Victoria 10* <[http://www.partnerships.vic.gov.au/CA257085_00035EB6/WebObj/Policy/\\$File/Policy.pdf](http://www.partnerships.vic.gov.au/CA257085_00035EB6/WebObj/Policy/$File/Policy.pdf)> at 10 September 2006.

partner, including construction and the implementation of tolling, have only a modest impact on demand. The level of the toll has a substantial impact on demand, but this is normally determined as part of the contract.

The same considerations apply with even greater force in the case of public services such as schools and health care facilities. These services are paid for, or at least heavily subsidised by, the public sector. It is evident that, as the main driver of demand, the public sector is in the best possible position to manage demand risk. So, for example, the public sector might choose to increase the number of years of schooling, as has been done with the introduction of a 'prep' year in Queensland, or to encourage more students to stay on at school. Alternatively, it might encourage less academically-minded students to seek vocational training outside schools. Under a PPP arrangement, the private party must bear the risk associated with such decisions. This will be reflected either in higher charges or in 'take or pay' arrangements that transfer risk back to the public sector.

The transfer of demand risk necessarily involves contractual terms that create risks of their own. The conditions under which prices may be increased and the guarantees provided to private parties about policy decisions that affect demand are frequently ambiguous and have been the subject of litigation in many cases. The only way to avoid ambiguity, in general, is to write contracts that negate much of the supposed transfer of risk to private parties.

Despite all of these considerations, transfer of demand risk and bundling into a single contract are defining characteristics, distinguishing PPP arrangements from modernised forms of public procurement, which typically involve the transfer of construction risk and significant contracting of operations. Many of the problems that have arisen with PPP arrangements may be traced to these characteristics.

IV IMPROVING PPPs

I have previously argued that the risk allocation properties of PPP contracts could be improved through the inclusion of put and call options, exercisable at intervals of five years.⁷ Using such options, either party would be able to terminate the partnership at the specified date, with the private party receiving a lump sum payment determined by a valuation of the flows of payments and services remaining under the contract.

Put and call options could improve the transparency and risk allocation properties of PPP contracts. In particular, both parties would be protected from many of the risks associated with disputes over contractual terms. The result would be improved transparency, which would help to ensure that PPP contracts would be adopted only if they offered better services at lower cost than the public alternative.

Another important consequence of including put and call options in a contractual framework would be a more balanced relationship between the

7 Quiggin, above n 3, 446.

parties. This could be further enhanced by allowing either party's option to be exercised if the other party sought to divest their rights and obligations under the contract. This possibility has generally arisen when private parties have sold their assets, but it is conceivable that a government might seek to transfer its rights and obligations to another government or to a corporate entity.

With these reforms, it might be possible to make the rhetoric of partnership correspond more closely to reality. Given the inability of either side to extract large rents from ambiguous contracts, the probability of cooperation yielding mutual benefits would be enhanced.

Reforms of this kind might diminish the attractiveness of PPP arrangements to private parties. This would, however, only reflect the underlying reality that only a minority of infrastructure and other projects are suited to PPP arrangements.

V CONCLUDING COMMENTS

The management of risk is a central concern in any contractual relationship. Risk in contracting can be managed both by allocating foreseeable risks to the party best able to bear them, and through the creation of durable partnerships committed to the cooperative resolution of unforeseen risks. These points are recognised in official discussion of PPPs, but reality often fails to match the rhetoric. Reforms are needed to improve risk management and to ensure that PPP approaches are used when they truly represent value for money, rather than a politically convenient but economically dubious way of packaging infrastructure deals.