What are public-private partnerships?

Public-private partnerships (PPPs) are agreements between the public and private sectors for the provision of assets and/or services such as power, water, transportation, education, and health. Unlike traditional procurement contracts, PPPs allocate risks between the partners and create efficiency incentives for the service provider by linking payments to specific performance criteria. For example, a PPP for road maintenance specifies a target road surface quality to be maintained over a given period of time. In contrast, a traditional road maintenance contract provides for payment against a number of potholes or kilometers of road resurfaced. In the traditional model, the risks remain with the purchaser, and there are few efficiency incentives. In the PPP model, if the contractor does not ensure that road surfaces are maintained to the standards specified in the maintenance contract, payment could be withheld.

PPPs also allow the public sector to spread service delivery/infrastructure investment over the lifetime of the asset. For example, in a build-operate-transfer (BOT) contract for a new power station, the private partner provides the capital outlay for building the facility, which it should then recover by selling power to the public sector over a specified period of time. This improves public sector cash flow.

Why are PPPs attractive to governments?

Governments throughout the world have been using PPPs over the past 20 years for three key reasons. First, PPPs have been effective in helping governments respond to the increasing demand for infrastructure-related services. Second, by shifting the burden of capital spending to the private sector, PPPs can help governments do more with less. Third, PPPs contribute to enhanced efficiency in delivering services. Much of the improved productivity arises from the private sector making commercially-based decisions when designing, operating, maintaining, staffing, costing, and delivering investments and services. As a result, profits from operation and returns on investment are higher than under state ownership. In practical terms, PPPs are attractive because they can achieve through collaboration of the public and private sector what each, acting alone, cannot.

What are the different forms of PPP?

PPPs can take different forms depending on the nature of the procurement, desired allocation of risk, and investment requirements. As the following diagram illustrates, PPP contracts fall into five broad categories:

- **Service contracts** are the simplest form of PPP. The private partner does not operate any public assets, but simply contracts with the public sector to provide a specified level of service. These contracts are typically 1–3 years in duration, and are common in the road maintenance and health sectors.
- **Management contracts** typically involve the operation of public assets by a private partner. The private partner receives a management fee and, if there is risk-sharing, a profit-sharing incentive. Contract periods are usually limited to 3–5 years.
- **Leases** are similar to management contracts, but involve a greater transfer of operational risk as the private partner pays a lease fee and generates income solely from the use of the assets. Contract periods are typically 8–15 years.
- **Concession** contracts are the simplest form of PPP. The private partner does not operate any public assets, but simply contracts with the public sector to provide a specified level of service. These contracts are typically 1–3 years in duration, and are common in the road maintenance and health sectors.
- **DBO/BOT** contracts are similar to service contracts, but the private partner is responsible for the design and construction of the facility. Contract periods are typically 8–15 years.

Increasing private sector responsibility financing and risk

Degree of management independence and accountability

Contract duration

**Profit orientation**

Commercial SOE

Privatized SOE

SOE

Independent Public Body

Ministry

DBO/BOT

Concession

Lease

Management Contract

Service Contract
Design/Build-Operate-Transfer (DBO/BOT) involves significant investment by the private partner, which constructs and operates the infrastructure, often with an offtake agreement\(^1\) from the public partner. The assets are returned to public ownership at the end of the PPP. While the demand risk can be shared by the public and private partners, the operating and finance risks remain squarely with the private partner. Contract periods are often 20–30 years, allowing for return on investment.

Concessions transfer a maximum amount of risk (e.g., demand, operating, investment/finance, etc.) to a private operator in exchange for some form of exclusive operating license. Contracts normally demand new investment to expand services and may include the assumption of existing assets. These are the most complex of PPPs and require careful structuring and monitoring. Contract duration is typically 20–30 years.

When are PPPs appropriate?

In principle, PPPs can be used whenever they offer greater efficiency than the public provision of services. Under this definition, only very small projects where procurement and monitoring costs outweigh potential efficiency gains or strategic services (e.g., the operation of defense infrastructure and court systems) are beyond the scope of PPPs. In the health sector, for example, very small output-based service contracts have been structured for the provision of hospital laundry services in New Zealand, while in Cambodia, full health services in 12 districts are contracted out to nongovernment organizations that provide both fee-based and free services. Both cases have resulted in net savings to the Government over public service provision. In the United States (US), even prison services are contracted out to the private sector.

PPPs are not, however, the answer to all infrastructure or public service shortcomings. Successful PPPs require careful risk allocation and a strong enabling environment, which are a challenge to achieve. In addition, most PPP failures arise from poor contract preparation, inadequate risk allocation, the absence of competitive and transparent tendering procedures, and poor contract monitoring and enforcement systems. In the United Kingdom (UK), the recent failure of the Metronet PPP for the operation of 9 of London’s 12 Underground lines was largely due to poor contract structuring, where the costs of operations were not adequately forecasted. In Sydney, Australia, the Cross City Tunnel PPP encountered similar difficulties. Moreover, even in mature PPP markets such as the UK, PPPs represent less than 20% of all infrastructure investments in value terms.

Are PPPs suitable for Pacific island economies?

Absolutely. PPP arrangements are not new in the Pacific region, but only a few countries have established formal policies and institutional frameworks to promote them. Success stories in the Pacific region include:

- The service contracts for road maintenance in Samoa which, in 4 years, have resulted in a 400% increase in productivity;
- The service contracts for shipping services in the Fiji Islands, which have generated significant benefits to the local economy, at a cost lower than what would have been possible through government ownership and operation of the vessels; and

There have, however, been PPP failures as well. In Papua New Guinea, for example, a BOT contract for the supply of electricity was structured without considering potential currency risks. Thus, when the national currency devalued against the US dollar, the spread between the cost of purchasing power from the BOT partner (in US dollar) and the revenue from consumer payments (in local currency) widened substantially to the detriment of the public sector purchaser.

Do PPPs result in higher costs to consumers?

No, not if they are well-structured. Because PPPs are contracts, the actual costs of service delivery are publicly known, and this helps increase transparency. As properly structured PPPs generally result in lower costs of service delivery than public provision, savings could be passed on to consumers. To be successful, PPPs must allow for full cost recovery, but this is not to suggest that all subsidies should necessarily be abolished. The unpopularity of a number of water PPPs in Latin America was due to governments’ failure to recognize the amount of free water that was being distributed by the public service, so that when distribution came under the control of a private provider, which was more efficient in accounting for water, the “free” water services were discontinued. In such cases, the burden on poorer consumers could be avoided by including a subsidized service component to the PPP. Indeed, many water concession agreements now have a “lifeline service” or community service obligation component.

\(^1\)An offtake agreement is a contract to purchase a given output over a period of time. The contract usually specifies the quantity and quality of output to be purchased, and can also specify the price to be paid.
What can governments do to support successful PPPs in the Pacific region?

• Formulate effective policy, signaling government’s willingness to engage with the private sector for the delivery of public services and triggering a review of potential PPP opportunities. To be fully effective, the policy must be mainstreamed into sector investment plans.

• Make it legal, by allowing for PPPs in public enterprise and public sector legislation. Although many countries in the Pacific region have already developed PPP laws, this is not required if good policy and legal space for PPPs already exist.

• Create the institutional framework for PPPs, which should include clear guidelines for project tendering, evaluation, and award. Many countries (including the Fiji Islands and Indonesia) have already formed PPP units—an essential step when there is limited expertise for project development. These units are responsible for selecting project ideas initiated by government departments and state-owned enterprises in an initial screening process and shepherding approved projects through to the contract structuring stage.

• Develop government’s risk management and contract monitoring and evaluation capabilities. Risk management is essential to evaluate the magnitude of the risks assumed by government under PPP arrangements. Contract monitoring and enforcement ensures that government pays only for the level of service that the private partners have contracted to deliver. To reduce the risks perceived by a private partner in a PPP, an effective regulatory framework is required. This is particularly true in sectors that involve service quality measurement and tariff adjustment (e.g., power, telecommunications, transport, and water). Where such regulatory frameworks do not exist, PPP contracts become more complex, as all the conditions that would normally come under the authority of a regulator must be integrated into the PPP contract.

PPP work can start now

While a sound institutional and policy framework should substantially facilitate the development of PPPs, it does not have to be complete before new PPP work can be initiated. Although the policy and legal aspects of the framework are fundamental, institutional strengthening can be developed in parallel with the structuring of new PPP opportunities. Action can be taken now to achieve in partnership what neither the public nor the private sector is achieving alone.