

# Public Private Partnerships in Ireland: An Overview

by John Scally\*

## ABSTRACT

This paper provides an overview of the Public Private Partnership (PPP) process in Ireland. It examines the varying degrees to which private sector capital can be mobilised to produce goods and services that are traditionally provided by the public sector. Since the government can usually finance projects at a cheaper rate than the private sector, there must be some offsetting benefits that a PPP offers in order for the project to be viable. It considers the various advantages that a PPP approach can offer, including risk transfer, faster implementation, increased efficiency and improved quality of service. The PPP process also has important National Accounts and public finance accounting implications, which centre around the ownership of the asset and the allocation of risk. Expenditure on a PPP project can be considered as a non-government outlay, and therefore will not affect the General Government Balance in the same way as normal government investment expenditure, if the private partner bears the major part of the risk involved. In theory and in practice, however, PPPs are beneficial only if it can be demonstrated that they will achieve additional value for money compared with alternative approaches.

## 1. Introduction

Over the last decade or so Ireland has seen the size of its economy more than double (in nominal terms it increased by a factor of 2.6 – in real terms the increase is approaching double the level of real GDP in 1995), as we quickly converged to European standards of living. This relatively long period of very rapid economic growth has placed significant strains on existing domestic infrastructure. It was evident from the high rates of inflation, construction inflation in particular, and the historically low rate of unemployment towards the end of the last century, that the economy could no longer sustain double-digit growth rates. It was also clear that increasing difficulties were being encountered through growing pressure on the economy's infrastructure with the much higher level of economic activity in recent years. In recognition of the supply constraints that would be presented by a substandard infrastructural framework, the National Development Plan 2000-2006 outlined a substantial programme for improving and expanding domestic infrastructure, amounting to €51 billion over the lifecycle of the project. At the turn of the century, it was acknowledged that the ability to continue to attract Foreign Direct Investment and to sustain above average rates of economic growth (compared with our EU counterparts) depended critically on the development of the country's capital base, both physical and human.

\*The author is an economist in the Economic Analysis, Research and Publications Department. The views expressed in this paper are not necessarily held by the Bank and are the sole responsibility of the author. The author would like to thank Tom O'Connell, Michael Casey and Maurice McGuire for helpful comments.

Traditionally, infrastructural investment projects in Ireland have been funded by the Exchequer, or through a combination of Exchequer funding and EU transfers. However, in light of the successful transition of the Irish economy to standards of living on a par with that of the core European economies, EU transfers are unlikely to play an important role in the future financing of our infrastructure. Indeed, with the introduction of the new Member State countries into the European Union, and eventually the euro area, Ireland is set to become a net contributor to the European Union budget. In addition, looking further ahead, the budgetary implications of an ageing population are set to put pressure on the government's finances. Therefore, while the current state of the public finances is relatively healthy, the ending of EU transfers and the projected increased burden on social welfare and health care provisions associated with demographic trends mean that the traditional Exchequer funding route for capital projects may come under increasing pressure<sup>1</sup>.

At times of strains on the public finances, international experience suggests that the government can make use of private sector efficiencies to provide infrastructural services. In theory, oftentimes the private sector can come up with a more innovative approach at a lower cost than traditional procurement methods. This, together with recent developments in European accounting conventions, has brought in to focus alternative avenues that governments can pursue in order to satisfy capital investment requirements.

## 2. Mobilising the Private Sector

The assumption that the public sector is responsible for the delivery of basic services remains entrenched in many countries, including Ireland, but the method by which these services are created, financed, procured and delivered is changing. Recent years have seen a marked increase in cooperation between the public and private sectors for the development and operation of infrastructure for a wide variety of economic services, particularly in the transport, environment, education and health sectors. These Public Private Partnership (PPPs) have been defined as partnerships between public sector organisations and private sector investors and businesses for the purpose of designing, planning, financing, constructing and/or operating infrastructure projects which, in the past, have been provided through traditional procurement mechanisms by the state or other government bodies. PPPs recognise that both parties have certain advantages relative to the other in the performance of specific tasks. In theory, by allowing each sector to do what it does best, public services and infrastructure can be provided in

<sup>1</sup> When the public finances come under pressure, capital expenditure projects are often the first to suffer. In the 2003 Budget, when the government was trying to bring expenditure into line with revenue, day-to-day expenditure increases were curbed to a 7 per cent increase, while capital expenditure was actually cut by 2 per cent.

the most economically efficient manner. PPPs have had a relatively long history in some EU Member States, most notably in the UK, Spain and Portugal, but are a relatively recent phenomenon in Ireland.

Under the PPP model, the private sector partner usually becomes the long-term provider of a service, rather than just simply the up-front asset builders. The private sector partner is usually responsible not only for the construction of an asset, but also for its long-term operation and maintenance, and possibly the financing of the asset. When entering into a partnership with a private sector partner, a wide range of contractual forms may be adopted by the public sector, ranging from minimal private sector involvement to minimal public sector involvement. Varying degrees of contractual obligations have been identified in the PPP literature and the following three broad categories cover the spectrum of private sector involvement.

1. **Design and Build (DB)** Under this type of contract, the private sector is contracted to design and build an asset, which, on completion of construction, is handed over to the contracting authorities who maintain and operate the asset. This type of contract is generally not considered to be a PPP since all the operational, maintenance and even construction risks associated with the project ultimately lies with the public sector, in that if anything goes wrong, responsibility rests with the public contractor. Risks, therefore, as examined in section 4, are crucial in determining the status of a PPP.
2. **Design, Build and Operate (DBO)** Under this type of contract the private sector not only builds and operates the asset, but is responsible for its maintenance and operation for an agreed period. In this case, the private sector partner agrees to provide a service, and typically bears the additional risks associated with providing that service. Since the private party is involved over a longer time-frame than the DB contract and has more contractual obligations, there is an incentive for the private party to adopt a “whole-life costing” approach, whereby efficiency in the design and building phase take into account operational factors, increasing the overall efficiency of the project. In more traditional procurement mechanisms the design and building phases are separate to the operational and maintenance phases and are usually assigned to different parties. This separation, however, can result in inefficiencies in the form of higher operational and maintenance costs, since the design and building parties have no incentive to take into account operational issues.

**3. Design, Build, Operate and Finance (DBOF)/ Concessions** This form of contract is similar to the DBO contract but takes the private sector a step further since it finances the project from its own resources. In a DBOF contract, the private sector partner generally recovers the cost of the investment from regular payments by the public sector party over the operational period. In the case of a concession, the private sector party recovers some or all of the cost of their investment from direct user charges, for example, the West Link toll bridge. The majority of 'real' PPP contracts are usually DBOFs or concessions.

Advocates of PPPs suggest that mobilising private capital presents a number of recognized advantages over the traditional public sector procurement methods, including the ability to raise additional finance in an environment of budgetary restrictions. The potential advantages include:

- Acceleration of infrastructure provisions where a government financing constraint exists. PPPs enable the government to avoid a front-loading of a large capital expenditure into a flow of on-going service payments (see section 4 for the Eurostat decision and the implications on government finances).
- Faster implementation of projects. The assignment of design and construction obligations, combined with payments linked to services, provides an incentive to the private sector party to deliver investment projects in shorter timeframes, since their profits will suffer in the event of late completion or non-delivery of services.
- Reduced "whole-life costs". Projects that involve operation and maintenance of an asset over a prolonged period often provide the private contractor with an incentive to minimise the costs over the whole life of the project, increasing long-term efficiency.
- Central to the issue of PPPs is the issue of risk transfer. PPPs aim to optimise (but not necessarily maximise) the level of risk transfer and allocate it to the parties that are best equipped to handle it. Transferring risks to the private sector over a long period of time expedites project execution and encourages the whole-life costing approach, potentially increasing value for money.
- Improved quality of service. PPPs can make better use of the private sector's operational efficiencies. Harnessing the creativity and competitiveness of the private sector, along with increased innovation, can produce more favourable results than traditional procurement mechanisms. In addition, PPPs can facilitate the use of the most advanced technologies with the aid of large, high-tech multinationals.

Under the PPP arrangement, risks are transferred to the private sector on the basis of a monetary return for accepting those risks. For the private partner, there must be a return in the form of consistent and dependable future income streams, either from the government or directly from the final users. While regard must be taken to permit the private parties to realise financial returns, this must be matched with a concern to avoid the creation of non-competitive or monopoly rents. A balance must be struck between minimising the cost to the Exchequer, while at the same time providing reasonably competitive returns for the private party. The costs of forgoing the traditional public sector route is an important factor in considering the best approach to providing capital assets and services. The suitability of PPPs is often called into question since the public sector can usually finance projects at a cheaper rate than the private sector. Moreover, the costs associated with a PPP process can be high, involving complex contractual and legal issues, expensive tendering, procurement and appraisal issues. Therefore, like any project, a detailed review of the costs and benefits of private sector involvement versus public alternatives should be undertaken to ensure that a PPP enhances the public benefit.

### **3. Structure and Development of the PPP Process in Ireland**

The genesis of the PPP process in Ireland can be traced back to 1999, when the government approved a series of relatively small-scale pilot projects, including the building of five post-primary schools (DBOF projects), which are now completed. At the outset, support for the PPP process was limited, as capacity constraints had yet to materialise and the public finances were under little pressure, recording large surpluses – allowing increased scope for capital expenditure. However, as the size of the infrastructural requirement became apparent, and the budget surpluses disappeared, the government came under pressure either to curb capital investment or find alternative methods of financing badly needed investment projects. Interest in PPPs increased, particularly in light of the fact that some capital expenditure could possibly be moved to an “off-balance sheet” position.

The structural and administrative framework for PPPs was set in train with the establishment of the Central Public Private Partnership Unit in the Department of Finance. Comparable units with responsibility for individual sectors were established in key Departments of State. The Central PPP Unit also chairs two groups, which oversee the various stages of PPP project management. An Interdepartmental Group on PPPs represents all public service sectors, whose role it is to ensure coherence and consistency across the public service in developing PPP arrangements. The second group is a Public/Private Informal

Advisory Group on PPPs, which includes representatives from employers' organisations, trade unions and construction and civil engineers. In January of 2003, the National Development Finance Agency (NDFA) was established with the brief of finding new methods of financing major capital programmes, taking account of the need to "maximise efficiency, delivery, value for money and appropriate risk transfer across multi-annual programmes". The NDFA provides advisory services in the evaluation of costs and risks associated with various PPP options. Current guidelines require the State authorities to refer all projects over €20 million in value to the NDFA.

The balance between minimising the cost to the taxpayer and providing reasonably competitive returns to the private sector party have been embodied in the PPP structure in Ireland. There are six basic steps in the process that strive to ensure a value-for-money solution.

1. Before deciding whether to use the traditional procurement or the PPP route, a *preliminary appraisal* is carried out for all capital investment projects. This involves identifying the objectives of the project, the various options available for achieving those objectives, and the costs and benefits associated with those various options.
2. The NDFA then provides an *assessment* and advice on the costs and risk transfer benefits of the various options and has the function of advising on the optimal means of financing a project. Where it is optimal to do so, the NDFA has the power to fund the project itself.
3. The next stage is the *PPP assessment* stage. Here the relevant government department considers the rationale for using a PPP, the potential benefits it offers and the optimal type of PPP structure to use, that is, DBOF or concession etc.
4. This is the stage where the department or authority involved sets a benchmark for the procurement process. This *Public Sector Benchmark* (PSB) is the cost, discounted to net present value, of delivering and managing a project to an agreed upon specification, for a fixed term using the traditional procurement method. The cost includes capital cost, operating and maintenance costs, lifecycle costs, taxes, projections of third party income and the risks associated<sup>2</sup> with all the above. The PSB does not change throughout the procurement process. Only if non-market forces cause

<sup>2</sup> The risks associated are estimated using a probability rating. For example, if the effect of a delay in the construction of a project was estimated to cost €50 million, and the probability of it occurring at 30 per cent, then the risk value would be €15 million, that is €50 ml. × 30 per cent.



changes to project specification will the PSB be changed. Changes in the PSB will trigger a review of the original cost-benefit analysis and the current affordability of the project, since changes in the specification of the project may significantly increase its cost.

5. Based on the PSB, an *Affordability Cap* will be set on the project, which puts an absolute limit on the outturn cost in respect of the project elements provided by the private sector party. It is, in effect, a maximum cost the public sector party is willing to pay. It is usually set slightly over the PSB cost to allow for some profit on behalf of the private sector party. If the PPP bid exceeds the affordability cap then unless there are other significant benefits the procurement process will revert to a non-PPP process.
6. A *Value for Money Comparison* stage is then carried out after the selection of the best private sector bid and is designed to evaluate the total cost of the private sector bid, which includes the costs associated with using private sector finance with the costs of the traditional procurement method (the Public Sector Benchmark). It involves a comparison of exchequer cash flow in the case of the PPP option with exchequer cash flows of the PSB. Once this stage is complete, the decision is made whether to go ahead with a PPP, postpone or terminate the PPP option.

This structure goes a considerable way towards eliminating the possibility that private sector parties will simply ‘factor-in’ the costs associated with the additional risk assumed in a PPP, resulting in no net gain to the taxpayer. The competitive process outlined above helps keep costs at a competitive level. At the same time, this approach has the advantage that the private sector partners should produce more realistic project costing than in the past, where there has been an incentive to ‘bid low’ (to attract tender) and ‘finish high’ (to maximise profits).

The National Development Plan outlined an ambitious “minimum indicative” target for private investment in PPPs of €2.35 billion over the 2000 to 2006 horizon. The proposed distribution of the €2.35 billion, at the time of NDP publication, is illustrated in Table 1.

**Table 1: PPP Expenditure under the National Development Plan 2000-2006**

	€ million	PPP as a % of Total
National Roads	1,270	23
Water Supply	127	9
Public Transport/LUAS	381	60
Waste Management	571	69

The slowdown of domestic economic growth in mid-2001, and the associated deterioration in the public finances (albeit from a favourable position), resulted in delays in implementing the Plan, as the government attempted to keep to its commitment to maintain capital expenditure at about 5 per cent of GNP<sup>3</sup> (which is still about twice the European average). More recently, in Budget 2004, the PPP process (and capital expenditure commitments in general) was underpinned and strengthened by the introduction of five-year multi-annual capital spending envelopes covering the period 2004-2008, which set out targets for traditional and PPP investment. The envelopes include a total target of €3.5 billion for private sector investment in PPPs by 2008. In addition, a further €1.35 billion has been earmarked for PPP investment funded by user charges. These targets will see the PPP contribution to total government investment increase from 3 per cent of total government investment in 2004 to 15 per cent of total government investment in 2008. These capital envelopes are, however, conditional on the economic environment, the state of the public finances and fiscal sustainability, and could be subject to change at Budget time. If followed through, the envelopes will maintain government investment at 5 per cent of GNP over the 2004-2008 period, which is almost twice the EU average.

#### **4. Risk Transfer and the Statistical Treatment of PPPs**

As outlined, a key principle of PPPs is that risk should be allocated to the party best able to manage it. A risk, in this context, is defined as any factor that could threaten the successful completion of the project, in terms of time, cost or quality. The effective allocation of risk should generally have direct financial implications for the project, as the whole-life costing approach could result in lower overall project costs and enhanced value for money. The transfer of risk should provide the private sector party with an incentive to deliver projects on time and within budget. The objective for involving a private partner should be to achieve cost effective risk transfer and not just the transfer of risk for its own sake.

A recent decision by Eurostat, the EU's statistical office, has important implications for the accounting treatment of PPPs, and centres on the allocation of risk. On a European level, the decision coincided with EU Member States' calls for revisions to the *Stability and Growth Pact*. At the time, a number of member states were in breach of the 3 per cent limit imposed on the General Government Deficit. Recommendations to rectify the fiscal situation meant that some countries could be forced to curb capital expenditure. This was at variance with the objective of the European Growth Initiative – a proposal of the Italian EU

<sup>3</sup> Capital expenditure actually fell by approximately 2 per cent in 2003.



presidency in the second half of 2003, which focused on stimulating growth-enhancing investment, involving both national institutions and private sector capital. It was hoped that any expenditure undertaken within the PPP framework would be considered as “off-balance sheet” and would, therefore, not impact on General Government capital expenditure and thus the overall General Government Balance.

The decision made in February 2004 by the Eurostat Task Force on Public Private Partnerships went some way to providing increased scope for an “off-balance sheet” classification of PPP assets. Eurostat recommended that the assets involved in a PPP should be classified as non-government assets, and therefore would not affect the General Government Balance, if *both* of the following conditions are met:

1. **the private partner bears the construction risk, and**
2. **the private partner bears at least one of either availability or demand risk.**

#### ***Construction Risk***

This refers to the risk that the PPP assets may become available later than the fixed date in the contract, or that the output does not meet the specified standards. This risk also covers the possibility of unexpected additional costs, or technical deficiencies. Compensating payments by the government to third parties for negative externalities arising from the project would indicate that the private party is not bearing all the construction risks. Moreover, if the government has an obligation to make regular payments to the private partner without taking into account the effective state of the asset, this would be evidence that the government is bearing most of the construction risk.

#### ***Availability Risk***

This is the risk that the private sector partner is not in a position to deliver the volume that was contractually agreed upon, or fails to meet safety or public certification standards, as specified in the contract. For example, this would include capacity constraints that occur as a result of substandard infrastructure. It also applies where the private partner does not meet the required quality standards relating to the delivery of a service. For the assets to be considered as a non-government asset (off-balance sheet) the public partner must be entitled to automatically reduce significantly the payments to the partner (so that it affects the profits of the private partner), in the event of non-delivery of services. The threat of significant penalties provides a strong incentive for increased efficiency on the part of the private partner.

***Demand Risk***

This is the risk that the demand for services from the project may be significantly higher or lower than expected when the contract was signed, where the private sector partner is not itself responsible for the variability of demand (availability is satisfied). It may be where there is a change in the final users' behaviour due to factors such as the business cycle, new market trends or technological obsolescence, that is, factors outside the control of the private partner (normal economic and business risks). The asset is considered a government asset if the government is obliged to ensure a given level of payment to the partner independent of the level of demand expressed by the final user. This does not apply, however, when the shift in demand is as a result of an obvious government action.

In general, the main risks relate to the variability of the income that the asset generates. If the construction risk, and one or other of the availability or demand risk, is borne by the private sector partner, then the asset can be considered as "off-balance sheet". Therefore, if the PPP asset is not considered as a government asset, the capital expenditure has no 'lump sum' impact on the General Government Balance. Regular purchase by the public partners of services from the private sector with regard to the asset will qualify as government expenditure. In this case the government can avoid the initial up-front capital costs and spread the cost of the asset over the lifecycle of the project. Prior to this, a government commitment to pay a private sector contractor for the use of an asset over a lengthy period would have meant that the entire amount payable over the concession period would have to be counted against government borrowing *in the year that it occurred*, rather than a series of yearly payments, making it difficult to finance a large and lengthy project without potentially putting a significant strain on public finances and in particular, on the *Stability and Growth Pact* parameters. In the long run, however, the effect of a PPP on the level of government debt is potentially the same as that of a more traditional procurement. The PPP allows the debt to be 'smoothed' over the life-cycle of the project.

Currently, PPP capital infrastructure spending that is not financed by user charges is being treated as part of the capital envelope and as part of government capital expenditure for 2004. The Eurostat ruling should provide more freedom for the government to move more projects with significant risk transfer to an off-balance sheet position. In Budget 2004, the government indicated that, in addition to the capital envelopes, additional targets of €150 million for 2004 and €300 million for each year up to 2008 have been set aside for PPP projects to be financed by user charges. Consistent with the Eurostat ruling, these will be considered as off-balance sheet.

## 5. Conclusions

The option to mobilise private capital in implementing infrastructural projects that were previously considered the job of the public sector is of potential use, particularly in light of Ireland's large infrastructural needs. The Eurostat ruling provides a helpful clarification regarding the National Accounts and public finance implications of PPP projects, providing increased scope for usage without endangering Stability and Growth Pact considerations and medium-term fiscal sustainability – provided there is the sufficient and optimal amount of risk transfer. Since the PPP phenomenon is relatively new in Ireland, progress to date has been relatively good – although not without its problems. However, several major infrastructural projects have been completed successfully under the PPP framework. The administrative, legal and financial structures have been put in place and the process enjoys the support of the social partners. The process, however, is not without its drawbacks. The Department of Finance has stated that it is adopting a 'learning-by-doing' approach and is incorporating lessons learned from earlier pilot projects into the current PPP process.

With regard to the first phase of PPP projects, and indeed the international experience in PPPs, the cost-benefit analysis should be the primary concern. In the procurement and appraisal stages, the incentive to 'bid low and finish high' should be minimised. Cost overruns in major public capital projects are rife in the international literature on PPPs. Indeed, in the case of Ireland, where PPPs have been relatively limited to date, the 2003 Mid-Term Review of the National Development Plan reported that there has been a significant amount of underestimating costs and delivery delays in some major Irish infrastructure projects. Transferring the risk of cost overruns to the private party through PPPs could limit this risk. However, in the case of user charges (where the private party recoups its investment directly from the consumer) a PPP would be of little benefit to the consumer if the costs associated with the risk transfer are simply built into the user charge. In considering future construction contracts for capital investments, allowances could be made for future cost and specification changes, and in this regard, the Central PPP Unit in the Department of Finance is considering the option of fixed price contracts for the delivery of services. Incentives, in the form of bonuses and performance based payments, could be used to encourage private sector parties to finish projects on time and within budget. The current PPP structure should ensure more realistic project costing, while at the same time providing a competitive process, delivering value for money.

Finally, the pick-up in the domestic and international economy strengthens the case for continued substantial investment in Ireland's infrastructure. PPPs provide the government with an

additional option to finance and undertake capital expenditure projects. Like any investment, a careful cost-benefit analysis should be undertaken. Since all PPPs are heterogeneous, the specific long term costs and benefits need to be weighed up and considered in relation to alternative possibilities. PPPs should be considered if it can be demonstrated that they will achieve additional value for money compared with other approaches.