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Risks and the financing of PPP: Perspectives from the financiers

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ABSTRACT

Public private partnerships (PPP) are an established model for most governments internationally to provide infrastructure-based services, using private finance. Typically the public authority will sign a contract with a special purpose vehicle (SPV), which, because of the holistic nature of PPP, in turn sub-contracts the finance, design, construction, maintenance and soft services to companies that are often related to its shareholders. Thus there is a considerable network of linked organisations that together procure and provide the PPP project.

While there is an increasing body of research that examines these PPP projects, much of it is interview or case study based so that the evidence is drawn from a small number of interviews or cases in specific sectors. It also focuses on the public sector procurer and the private sector contractor in the network of organisations. Although it has been recognised that the perceptions of the financiers may vary from those of other key PPP players there is much less research that focuses on the financiers.

In this paper we report the results of a postal questionnaire survey, administered to 109 providers of senior debt and equity, from which the response rate was just less than 40%. We supplement these findings with a small number of illustrative quotes from interviewees, where the cited quote represents a commonly held view. We used SPSS and Nvivo to analyse the data.

The findings show that when assessing PPPs financiers perceive a very wide range of risks as important, and that it is important to them that many of these risks are either insured or allocated to sub-contractors. When considering participating in PPPs, financiers agree that working with familiar partners on familiar projects and in familiar sectors is important, which may raise barriers to entry and undermine competitive processes.

1. Introduction

Public private partnerships (PPP) are an established model for governments internationally to provide infrastructure-based services, using private, as opposed to public, finance. Although the involvement of the private sector in public infrastructure projects is not a new phenomenon, the PPP model enables and encourages private sector involvement in the provision of public services and the scale of private finance is unprecedented. Globally, the PPP market reached a record high of $68.6 billion in 2007 (Project Finance, 2008), and although PPP financing continued to be strong throughout 2008, by 2009 the impact of the credit crunch began to take effect so that the market was worth $55.5 billion by the end of 2009 (Project Finance, 2010).

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While other markets are significant in size especially in Europe, and India, where there has been rapid growth (Project Finance, 2008), the UK is recognised as a global leader in the use of PPP. The previous Labour administration used PPP as a means of shifting traditional responsibilities for providing public services from central and public control to private sector companies. Since the inception of the policy in the 1990s, over 900 projects worth over £70 billion have been procured in the UK (PartnershipsUK, 2009). By 2010 when it lost power the Labour administration's spending on PPP represented some 10%–15% of total government investment. While the investment plans of the new coalition government are currently under review and likely to be less expansive, politically both constituent parties are committed to private sector involvement in the provision of public services. The PPP concept is thus important internationally and in the UK.

PPPs involve a clearly defined project financed by the private sector, which shares the associated risks and rewards with the public sector. While PPPs may take a variety of forms, this paper is concerned only with the time and cost specific (English, 2007) long-term contractual arrangements under the UK's Private Finance Initiative (PFI). In these projects the private sector designs, builds, finances and operates infrastructure assets, such as roads, hospitals, and schools, in return for a revenue stream that is used to repay debt, fund construction and operations, and provide a return to investors (Pollock & Price, 2004). This revenue stream takes the form of an annual unitary charge paid by the public sector procurer.

In terms of the contractual arrangements, typically the public authority will sign a contract with a special purpose vehicle (SPV) which is usually formed specifically to undertake the project. The SPV is normally owned by a consortium which, because of the holistic nature of the contracts, will typically include two or three companies with the range of skills necessary to finance, build and operate the required facilities. The SPV, which is usually a shell company, in turn sub-contracts the finance, design, construction, maintenance and soft services to companies that are often related to its shareholders. Thus there is a considerable network of linked organisations that together procure and provide the PFI project.

There is an increasing body of research that examines these projects. While a small number of papers, reviewed below, examine the financiers in this network of organisations, more typically, such work focuses on the public sector procurer and the private sector contractor (see for example, Bing, Akintoye, Edwards, & Hardcastle, 2005a, b; Broadbent & Laughlin, 2002, 2003, 2005; Broadbent, Gill, & Laughlin, 2003, 2004; Demirag, 2004; Demirag, Dubnick, & Khadaroo, 2005; Edwards & Shaoul, 2003a, 2003b, 2004; Edwards, Shaoul, Stafford, & Arblaster, 2004; Froud, 2003; Khadaroo, 2005, 2008; Shaoul, 2005a, 2005b; Shaoul, Stafford, Stapleton, & MacDonald, 2008). The paucity of research focussing on financiers is an important omission because they are one of the more important stakeholder groups and their perceptions may vary from those of other players (Broadbent, Gill, & Laughlin, 2004). In particular, they may have different perceptions of the risks, returns and structures necessary for PFI compared with other stakeholders (Gallimore, Williams, & Woodward, 1997). Attitudes to risk are especially significant because, although PFI was not originally devised as a policy for managing risk, risk has emerged as a key feature that legitimates the shift in public services management (Froud, 2003).

Risk has been defined as 'the probability that a particular adverse event occurs during a stated period of time or results from a particular challenge' (Royal Society, 1983, p.22), but it also involves an activity or decision where either the outcome or consequence is less than certain, and at times both of these are uncertain (McKim, 1992). Although PFI may rest on a conceptual conflation of risk and uncertainty (Froud, 2003), HM Treasury (1997, p.36) does acknowledge this distinction describing risk as 'referring to the likelihood of something going wrong', and uncertainty as occurring when 'the outcome of a course of action is indeterminate or subject to doubt'. While there is little agreement on what these two terms mean, the distinction is centrally concerned with 'calculable probabilities' (Froud, 2003, p.569). Where there is no possibility of placing a numerical probability on whether an event will occur or not, the unclear future state is referred to as an 'uncertainty', whereas risk involves the possibility of placing some 'calculable probability' on a future event occurring (Broadbent, Gill, & Laughlin, 2008). However, Helliar, Lonie, Power, and Sinclair (2001) argue that managers tend to ignore probabilities and do not calculate expected values for different decision outcomes. Instead, they argue, managers focus on the size of any possible loss; they exhibit loss, rather than risk, aversion.Furthermore, in practice uncertainties may be buried deep in the PFI contracts rather than being explicitly considered as part of decision-making in either the public or private sectors (Broadbent et al., 2008).

This paper focuses on the financiers and contributes to the literature by focussing on the factors that cause them to participate in a PFI project, their perceptions about the risks in PFI, and the ways in which they limit those risks. The multiplication of the notion of risk in hybrid organisational forms identified by Miller, Kurunmaki, and O'Leary (2008) is especially true of PFI. Early categorisations provided by the NAO (1999) and HM Treasury (1999) include risks associated with: design and construction; commissioning and operating; demand; residual value; technology/obsolescence; regulation; project finance; contractor default; and political/business. Recently, despite the claims that IFRS reporting standards would remove the possibility of off balance sheet accounting for PFI, Asenova and Beck (2010) identify availability and demand risk together with residual value risks as being most important in the context of PFI because they are most likely to affect the goal of off balance sheet project treatment. To the early categorisations of risk Grimsey and Lewis (2002) added *force majeure* and environmental risks. Our study focuses on the 21 specific categories of risks in PFI projects identified by HM Treasury (2003a), which include risks of an economic, technological, political, legislative and financing nature, each of which may vary in their significance over the project's life cycle.

The rest of the paper is organised into four further sections as follows. In the next (second) section we briefly review relevant literature and in the third section describe our research methods. Section four presents the empirical evidence and the final section offers a discussion and some concluding remarks.