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IMG REBEL

DISCUSSION PAPER

Aligning Public and Private Interests in a Public-Private Partnership: Safeguarding the public interest while allowing private returns

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Gaps in the provision of infrastructure are an increasing global concern. From maintaining and repairing dilapidated infrastructure in developed countries, to meeting development targets in emerging markets and developing resilient structures to adapt to climate change, the challenges are large and multifaceted. In addition to lacking the skills and expertise to tackle these challenges, governments face significant obstacles in accessing financing. A 2013 report by McKinsey & Company estimated that $57 trillion in infrastructure investments will be required between 2013 and 2030 to meet the projected growth in global GDP (McKinsey Global Institute, 2013).[1]

In order to confront these complex infrastructure challenges, governments are increasingly relying upon private sector skills, innovation and investment. A public-private partnership (PPP) model allows the private sector to participate more actively in infrastructure projects, including in the design, operation, management and financing of projects. This distinguishes PPPs from "traditional" procurements, in which governments retain the responsibility for funding, managing and operating the project.

However, involving private parties in infrastructure projects—traditionally seen as "public goods" in economic theory—is not without controversy. Concerns about investors reaping excessive private returns at the expense of the taxpayer, or about the public agency being forced to renege on policy objectives, continue to prompt governments to be cautious in recommending PPP delivery models. As a result, PPPs represent only a fraction of overall investments in infrastructure, even in mature markets.[2]

Although PPPs may not be a panacea to addressing all of the global infrastructure challenges, their ability to harness private sector expertise, innovation and financing can help governments confront complex challenges. A successful PPP should allow the public sector to not only safeguard, but even advance, its public policy objectives, while also allowing the private party to generate its required return. Building a successful partnership between the public and private sectors is inherently challenging; focusing on the right mechanisms, however, can result in a win-win for each party, while also creating the "best deal" for society.

[1] The World Economic Forum and The Boston Consulting Group (2013) estimated a global infrastructure gap of US$1 trillion annually.

[2] For example, in the United Kingdom, which has one of the most mature PPP markets, approximately 85 per cent of public infrastructure was still delivered via conventional delivery methods between 1998 and 2003. For more information, see HM Treasury (2003). In addition, the World Bank (2015) estimated that between 2002 and 2010, only 15–20 per cent of global infrastructure was delivered via a PPP approach.

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1. PPPs are about leveraging the best assets and ideas of the public an private sectors in a successful long-term partnership that generates value for money.

At the heart of a government's reasoning for pursuing a PPP delivery model lies "value for money" (VFM). A PPP approach should be pursued when involving the private sector allows an infrastructure project to generate greater VFM—or a greater positive net gain to society—than if the project were to be procured via a conventional approach. VFM is achieved when a PPP project is able to generate (i) cost efficiencies, through lower construction, operational and/or maintenance costs; (ii) time savings, through an earlier completion of the project; and/or (iii) quality enhancements, through enhanced service provision.[3]

Generating VFM, however, is first and foremost a public sector objective—not a private sector one. This reveals an inherent challenge for PPPs: namely, reconciling the different interests between the public and private sectors. A key objective in structuring a PPP contract is, therefore, to align interests such that each party is incentivized to pursue goals that are in the long-term best interest of the project.

2. Public and private interests are not automatically aligned, which can result in conflict and erode value for money if not properly managed.

The public interest in a PPP is typically to maximize social welfare from an infrastructure good. The public sector will seek to deliver an infrastructure asset at the lowest possible cost to the taxpayer and at the highest possible benefit for the end users, which could be drivers, in the case of a highway PPP; patients, in the case of a hospital PPP; or students, in the case of a school PPP. However, a public agency may also have more specific targets. It may seek to ensure that the project fits with its policy objectives for national and/or regional economic growth, job creation, and budget allocation. It may want to guarantee that the project meets its environmental and social targets by ensuring that the needs of special interest groups, communities, or disadvantaged groups are met. Governments will also typically want to confirm that the procurement and contracting process is transparent, accountable and democratic (New South Wales Government, 2012).

The private interest in a PPP, on the other hand, is represented in the special purpose vehicle (SPV), a legal entity whose sole responsibility is to execute the project's contract. The contract reflects the underlying interests of all parties of the SPV: the equity investors, whose interest is to ensure an adequate return on capital invested; the financiers, who want to ensure sufficient cash flow to meet annual interest and principal payments ("debt service coverage"); and the subcontractors, who want to ensure fair compensation for services delivered. In a PPP transaction, the private party will therefore have different objectives than the public agency, such as ensuring that (i) the project is financially viable and technically implementable and manageable; (ii) the most important risks—whether political, legal, economic or project-related—have been identified and managed; (iii) the governance and policy framework is stable and predictable; and (iv) regulatory and administrative processes are undertaken within a reasonable time frame. A distinction can also be made between the private interest during the procurement stage—which is to deliver a fully compliant and optimized bid that allows the private party to win the contract—and the contract execution stage (see Table 1).

[3] Definitions of VFM vary depending on the jurisdiction. The United Kingdom's HM Treasury (2006), for example, defines VFM as "the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the good or service to meet the user's requirements." Similarly, the European Investment Bank (2015c) states that a "PPP project yields value for money if it results in a net positive gain to society which is greater than that which could be achieved through any alternative procurement route."

TABLE 1: Public and Private Interests in PPP

PUBLIC SECTOR INTERESTS	PRIVATE SECTOR INTERESTS
Overall interest: Ensuring an adequate economic and social return on investment	**Overall Interest:** • Ensuring an adequate *financial return* on investment (in the case of equity investors) • Ensuring sufficient debt service (in the case of debt financiers) • Ensuring fair compensation (in the case of subcontractors)
Throughout the project life cycle: • Ensuring that the project is aligned with its policy objectives: regional or national spending/budget; regional or national development, including job creation or economic growth; employment rates or environmental objectives, etc. • Ensuring that the project delivers better value for money than the public sector alternative, which involves asking questions such as: Is the user fee appropriate to the level of service obtained? Is the level of taxpayer contribution reasonable? • Ensuring that the interests of communities and special groups likely to be affected by the project are protected, and the groups are engaged in the consultation processes. • Ensuring that the project meets the needs of, and can be accessed by, disadvantaged groups. • Ensuring that the project approval process is transparent, accountable and relatively democratic. • Ensuring that all public health and safety standards are met, as well as any other legislation such as privacy, environmental, labour, etc.	**During the procurement stage:** • Delivering a fully compliant and optimized bid to win the PPP contract **During the contract execution stage:** • Ensuring that the project is financially viable and technically implementable and manageable • Ensuring that political, legal and other risks are manageable • Ensuring that the governance and policy framework is stable and predictable • Ensuring that regulatory and administrative processes are undertaken in a reasonable time frame.

Source: New South Wales Government (2012) and IMG Rebel.

In addition to having differing interests, the public and private parties may also have distinct cultural perspectives. At times, it may seem as though the public and private parties are speaking a different language during a PPP project (see Table 2). For example, whereas the private party seeks to generate dividends for its *shareholders*, the public agency seeks to address the concerns of *stakeholders*—local citizens, users of the facility, political representatives, or disadvantaged or minority groups, etc. (Federal Highway Administration, 2012). Although these cultural differences do not inhibit the creation of a successful partnership, being aware of them allows parties to understand the other side's perspective in a PPP contract.

TABLE 2: Public and Private Sector Cultural Perspectives

PUBLIC SECTOR	PRIVATE SECTOR
Projects: Seeks to address transportation needs by developing "projects" to improve the infrastructure network.	***Deals***: Sees the process in terms of negotiated transactions.
Stakeholders: Seeks to address the concerns of various parties, including local residents, facility users and political representatives.	***Shareholders***: Seeks to generate dividends for its stockholders.
Process: Applies and complies with prescriptive, standard operating procedures designed to provide uniformity, minimize risk and build consensus among stakeholders.	***Outcome***: Demands greater flexibility and expediency to arrive at final objective.
Policy goals: Develops projects to achieve policy goals such as improvements to mobility and safety.	***Profits***: Interested in a competitive return on investment.
Transparency: Seeks to share information with the public to ensure public participation and accountability.	***Confidentiality***: Protects intellectual property and the competitive advantages derived from innovations.

Source: Federal Highway Administration (2012).

Maximizing both the public interest in social and economic returns and the private interest in financial returns may seem inherently challenging. However, the differing interests and cultural perspectives of the public and private sectors are the key advantages of a PPP, which is about leveraging the best assets and skills of the public and private sectors in a long-term partnership to generate VFM. Indeed, the most successful PPPs acknowledge these differences and leverage the strengths of both parties by developing mechanisms within the procurement and implementation stages that align these interests.

3. During the procurement stage, the public agency should provide clear and specific evaluation criteria that reflect its policy objectives for the project.

The criteria for evaluating private sector bids is a powerful tool for ensuring that the proposals received reflect the public sector's objectives for the project. The key interest of the private party during the procurement stage is, of course, to win the contract. As a result, the private party will optimize its bid in order to score as high as possible on the evaluation criteria provided by the public agency. The public sector can capitalize on this competitive procedure by ensuring that the evaluation criteria reflect its specific objectives for the project—such that the bidder will have an incentive to optimize its bid along the public agency's ambitions.

Typically, public agencies narrow the list of potential bidders through a "pre-qualification" stage in order to ensure that only technically and financially qualified firms submit bids.[4] Subsequently, they may introduce "pass/fail criteria"[5] in the bid evaluation system to help ensure that every bid is compliant with key minimum requirements. These minimum requirements may be technical, administrative or financial elements that are important to the public agency. Public agencies may, for example, require that bids do not exceed a predetermined budgetary threshold, or that they meet certain design standards for civil works. Finally, agencies may evaluate the bids against the Public Sector Comparator, the most realistic public sector alternative. In Australia, for example, bids are evaluated quantitatively and qualitatively against the Public Sector Comparator in order to determine which bid provides the best VFM outcome (Infrastructure Australia, 2008).

The most important tool for aligning public and private interests can be found at the bid evaluation stage,[6] when the public agency selects the preferred partner based on either "best value" or "lowest price." In most conventional procurements "lowest price" is the evaluation criterion of choice. Evaluating bids solely on price, however, is not adequate to account for the inherent complexities of large-scale PPP projects, nor does it provide the public agency with any guarantee that its specific policy objectives will be met.

A "best value" bid-evaluation system is the most effective method for aligning interests. Selecting the winning bidder based on a "best value" bid—in other words, the best quality available for the lowest price—rather than solely on "lowest price" will allow the public agency to consider other factors such as quality (of service or design), timing of completion and even risk allocation. In Australia, for example, the public agency considers innovations and novel designs that are outside the original scope if they result in long-term savings or greater sustainability of service.[7] Bids are also evaluated based on the risks that are transferred from the public agency to the bidders. Relying on "best value" to evaluate bidders not only allows public agencies to pursue a range of different objectives, but it also allows bidders to differentiate themselves in ways other than on price alone.

Governments pursue many variations of the above-mentioned mechanisms to achieve their interests. In Chile, for example, highway bids are evaluated based on prescribed toll levels and a variation of the "lowest price" mechanism, namely, the lowest present value of revenues. This allows the government to mitigate traffic risk for the private sector and regulate the amount of toll revenue the

[4] For more information on the prequalification stage, please refer to European Investment Bank (2015b).

[5] For more information on pass/fail criteria, please refer to European Investment Bank (2015a).

[6] For more information on the bid evaluation stage, refer to European Investment Bank (2011).

[7] For example, "a bid for a hospital facilities contract may incorporate a novel design which reduces the cost to government of delivering medical services in the facility" (Infrastructure Australia, 2008).

concessionaire can collect.[8] In South Africa, bids are evaluated not only on price and functionality, but also on ability to contract with historically disadvantaged individuals or groups (the "Black Economic Empowerment Score") and implement reconstruction and development programs.[9]

In order to achieve their policy objectives through the bid evaluation process, public agencies must provide clear parameters and scoring mechanisms. A clear scoring system—one that specifies the monetary value of a point (or percentage point) and the number of points associated with each criterion—will provide the bidders with guidance for optimizing their bid and the public agency with predictability in evaluating the bids. Unambiguous scoring is particularly important when referring to qualitative or non-monetary objectives, such as those related to timely completion or quality of service. If the public agency attaches value to early completion of the project, for example, it should monetize that value—allocating one point to one week earlier completion, and stipulating that one point is equivalent to US$100,000, for example. Of course, the exact structure of the bid evaluation criteria should be project specific, to accommodate the public agency's specific objectives for the project.

The purpose of the evaluation criteria should be to make clear to the bidders what is important to the public agency and what is not. The clearer the mechanism, the easier it is for the bidder to strive for the optimal scoring, which concurrently will reflect the public sector's objectives. It is not sufficient for the public agency to have an intricate internal bid evaluation system that it does not share or communicate with bidders. Vague evaluation criteria may result in confused bidders who are unsure about how to optimize their bids, as well as unexpected outcomes for public agencies.[10]

4. An incentivized payment mechanism, linked to a performance monitoring system, is the core of aligning public and private interests throughout the contract's life.

The incentivized payment mechanism, including the performance monitoring system, lies at the heart of ensuring that the private party performs according to the agreed-upon (public sector) objectives for the project. A successful performance monitoring system is made up of three main components:

1. *Output-based specifications: Output-based specifications and/or key performance indicators (KPIs) should reflect the public agency's national or local policy objectives for the PPP project.*

Output-based specifications stipulate the results that a private party is expected to achieve during the construction of an asset and/or the provision of a service. Specifying the "outputs" rather than the "inputs" of an asset or service is a key feature of PPP contracts. By providing the private party with incentives to develop innovative solutions and use life cycle costing, output-based specifications can create cost-efficiencies and enhance the quality of service delivery—both key drivers of value for money.[11]

In addition to driving VFM, KPIs can be used as a tool to advance the public sector's specific objectives for the PPP project. The KPIs should clearly reflect the public sector's overall goals for the project, as well as any local or national objectives. Despite the challenges associated with developing successful KPIs—and the tendency to rely on existing indicators—they should not be standardized, but rather tailored to each individual project.

[8] In the "least present value of revenues" approach, the public agency specifies the toll levels (and discount rate) and awards bids solely based on the lowest present value of accumulated revenues. The concession ends when the present value (in real terms) equals the present value listed on the bidding documents. This system allows the government to set tolls based on their possible impacts on traffic diversion, toll levels in adjacent concessions, and an economic assessment of the project (Lorenzen, Barrientos, & Babbar, 2001; Vassallo, 2006).

[9] The preferential procurement policy notes that special goals should include "contracting with persons, or categories of persons, historically disadvantaged by unfair discrimination on the basis of race, gender or disability" and implementing the programs of the Reconstruction and Development Programme as published in *Government Gazette* No. 16085 (Ministry in the Office of the President, 1994). For more information, refer to Annexure 19 of South Africa's PPPFA Treasury Guidelines (National Treasury of the Republic of South Africa, 2011).

[10] Unclear government objectives and evaluation criteria can result in confusion at the bidding stage and possibly raise transaction costs (Li, Edwards, & Hardcastle, 2005).

[11] For more information on performance-based specifications, see Turley (2013), Hartwig, Mumssen, and Schliessler (2005), or Liautaud (2001).

2. *<u>The performance-monitoring system</u>: Although PPPs shift responsibility for monitoring towards the private sector (which conducts self-monitoring), the public agency should nonetheless be proactive in independently verifying results to ensure that its specified project objectives are being met.*

In stark contrast to a traditional procurement mechanism, in which the public agency is fully responsible for monitoring the performance of its contractors, a PPP contract typically shifts the responsibility for performance monitoring to the private partner. The private party will typically establish its own quality assurance procedures and report to the public agency, a system that is significantly less costly for the government. For self-monitoring to be effective, however, the penalty in case of cheating must be sufficiently high. Because it is in the public agency's interest to ensure quality delivery, however, it should also undertake audits of the information provided. Independently verifying both performance monitoring and actual service delivery will not only allow the public agency to ensure that its objectives are being met throughout the life of the project, but it will also prevent any conflicts of interest between the two parties that could stem from either of them having financial interests in the results of the audit.

3. *<u>A payment mechanism</u> that is linked to the output-based specifications and KPIs aligns the interests of the public and private parties by incentivizing the private party to meet performance objectives.*

The public agency has an interest in ensuring that the private partner meets its contractual obligations throughout the life of the project. The public agency can incentivize private performance by linking the payment mechanism to KPIs—in other words, by making payments from the public agency contingent upon the performance of the private party.

Payment mechanisms typically function by imposing financial penalties—including payment deductions or retentions—whenever the private party underperforms. If penalties for non-compliance points reach a certain level, they can prompt even more severe consequences, such as additional costs at the private party's expense, or even a suspension or termination of the contract. The most challenging aspect is determining the size of the financial penalties, which must be large enough to encourage strong performance and align interests, but not so large that they risk causing defaults after minor breaches.

When these three components—the output-based specifications, the self-monitoring system and the payment mechanism—work together as one system, they incentivize the private partner to perform according to the agreed-upon quality and price objectives for the project, aligning interests between the two parties.

5. Other informal mechanisms can also be used to strengthen the working relationship between the public and private sectors.

Informal mechanisms can also be used to stimulate a collaborative working relationship between the public and private sectors. Although collaboration between the public and private parties can never be enforced, and will always depend on the voluntary willingness of the staff involved, there are nonetheless mechanisms that can help foster cooperative working relationships.

Some agencies establish informal forums for the public and private teams to periodically meet to discuss their vision for the PPP project and any potential issues. Such "partnering sessions" can initially serve as introductions between the public and private teams and as an opportunity for each side to discuss their respective ambitions for the project. Sessions can be held periodically to strengthen communication between the public and private sector, create awareness about each side's rights and responsibilities, and discuss any challenges or concerns that may arise.

Other agencies have chosen slightly more formalized mechanisms, such as "public-private working committees," to stimulate open communication during crucial project phases. Such working groups may be established during the construction phase, during the transition between the construction and operational phase, and/or as an "oversight committee" during the operational phase. In some cases, agencies may even establish joint offices for the project, in which public and private sector team members work

together in the same office, further facilitating open communication. Working committees are particularly effective when they encourage team members to raise concerns at an early stage, thus avoiding escalation into major disputes.

Establishing dispute resolution mechanisms early on that stipulate how disputes will be resolved can also provide clarity for public agencies and confidence for private parties. As a result of the long-term, contractual nature of PPPs, disagreements between the public and private parties are highly likely. Conflicts may arise over issues such as the quality of service, the revision of tariffs or the adjustment of contractual arrangements. Some disagreements may stem from differing interpretations of contract clauses. Establishing dispute resolutions mechanisms that encourage the resolution of issues through dialogue allows parties to avoid formal arbitration.

In the case of informal mechanisms for fostering collaboration, there is no standard formula, and policy-makers should be creative in thinking of ways to foster trust, collaboration and open communication between the public and private partners throughout the life of the PPP contract.

6. Conclusion

PPP delivery models present an opportunity for governments to advance their policy objectives—whether for national or regional growth, job creation or environmental sustainability—by tapping into the expertise, skills, innovation and investment abilities of the private sector. A successful PPP project is, indeed, about leveraging the best assets and skills of the private and public sectors in a partnership that creates VFM for society.

Creating a true partnership, however, is inherently challenging. Not only do the private and public sectors have different interests, but their styles of communication and negotiation may at times also seem incompatible. Truly successful PPPs acknowledge these differences and create mechanisms within the procurement and contract implementation stages to bring out the strengths of both parties, aligning their interests in the process. A "best value" bid evaluation system during procurement and a payment mechanism linked to performance indicators are the key mechanisms for achieving this.

Informal mechanisms such as partnering sessions, working groups and dispute resolution mechanisms may also help build trust and open communication, allowing issues to be raised at an early stage such that they do not escalate into conflict. Effective partnerships stem from shared interests, responsibilities and ambitions, and governments should not hesitate to invest time and effort into fostering and strengthening working relationships.

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