PUBLIC-PRIVATE PARTNERSHIP (PPP)

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What is PPP?

A public-private partnership ("PPP") is a term used to describe a government-sponsored initiative or scheme which involves the use of private finance to facilitate the provision of services to the public and/or the delivery of social infrastructure assets.

PPPs have been used to deliver infrastructure assets in the education, transport, defence and health sectors.

The need for PPP

There are usually two fundamental drivers for PPPs. Firstly, PPPs enable the public sector to harness the expertise and efficiencies that the private sector can bring to the delivery of certain facilities and services traditionally procured and delivered by the public sector.

Secondly, a PPP is structured so that the public sector body seeking to make a capital investment does not incur any borrowing. Rather, the PPP borrowing is incurred by the private sector vehicle implementing the project and therefore, from the public sector's perspective, a PPP is an "off-balance sheet" method of financing the delivery of new or refurbished public sector assets.

How PPP works

Parties, agreements and process

A PPP typically works as follows:

Bidding process. A public sector entity (usually a central government body/local authority) will identify the need to deliver a particular project, such as building a railway line or a hospital. The public entity will advertise the need for such a project and then run a competitive process under which private sector entities will "bid" in order to win the right to deliver the project. The winning private sector bidder is then awarded a "Concession" to implement its solution.

Project Company. A private sector entity will contract with the public entity and raise funds from investors and lenders in order to deliver the project (the "Project Company"). Usually, a new, separate, private company will be set up to be the Project Company in order to insulate the private sector sponsors of the project from the risk of insolvency if the project fails. This new company is known as a "special purpose vehicle" (an "SPV").

Sponsor. The activities of the Project Company will be managed by one or more private sector companies (the "Sponsor"). Typically, the Project Company is set up
as a direct/indirect subsidiary of the Sponsor. The Sponsors are usually the equity investment divisions of large construction or facilities management companies who want their construction or facilities management divisions to deliver the project. This arrangement will be documented in a "Shareholders' Agreement".

**Documentation.** The Project Company will enter into a contract with the public sector (the "Concession Agreement"). This is the key document detailing the terms and conditions of the project.

**Contractors.** The Project Company will enter into contracts to enable it to implement the project as it will typically have no employees. There will usually be one entity who is made responsible for the delivery of the facilities management services detailed in the Concession Agreement (the "FM Contractor"), and another entity who is made responsible for the provision of the construction works detailed in the Concession Agreement (the "Construction Contractor"). Certain responsibilities may be sub-contracted to other more specialist entities (the "Sub-Contractors").

**Funding.** The Project Company will obtain private funding in order to finance the PPP. Usually, funds are made up of a mix of investments by Sponsors (usually a small proportion of the overall debt) and loans from outside lenders (the "Lenders"). The Lenders will enter into "Financing Agreements" and "Security Agreements" with the Project Company, under which they agree to lend in return for security over the project. There will often also be "Direct Agreements". Project finance is provided on the strength of the cashflows of the Project Company, therefore the Concession Agreement is key. The payments made by the public sector entity are the sole income stream into the Project Company so if the Concession Agreement is terminated, the Project Company will have no means of repaying its debts. If a project starts to go wrong and the Project Company's right to deliver the contract is in danger of being terminated by the public sector entity then Lenders can rely on Direct Agreements to prevent the Concession Agreement from being terminated until the Lenders have had a chance to "step in" to the Project Company's shoes and attempt to remedy the situation.

Lenders may include commercial banks with experience in project finance, export credit agencies ("ECAs"), multi-lateral agencies ("MLAs") and development finance institutions ("DFIs"):  

- **ECAs** are governmental or quasi-governmental institutions. ECAs provide finance to promote national exports. An ECA can act either as a guarantor, an insurer or a lender. They have different models and they can be government institutions (e.g. ECGD, K-EXIM) or private companies operating on behalf of the government (e.g. Hermes, COFACE).

- **MLAs** are governmental institutions owned by a number of governments. Whereas an ECA's prime aim is to support national economic interests, an MLA's mandate is to further economic
development in developing countries. Major MLAs include the Asian Development Bank and African Development Bank.

- DFIs provide long-term development finance for private sector enterprises in developing countries. Examples include DEG (Germany) and FMO (Netherlands).

Diagram

ADVANTAGES AND DISADVANTAGES OF PPP

Advantages

- Investment decisions under PPP contracts tend to be based on a long-term view rather than short-term concerns.

- Risk and work are transferred to the party which is best able to manage it at the least cost, achieving **best value**.

- Projects go through a competitive pricing process, meaning that the cost of public services is benchmarked against market standards.
• The timings and costings tend to be more certain and therefore deliver better **value for money**. Where PPPs are not completed to budget, the private sector usually bears the costs.

• The cross-transfer of public and private sector skills, knowledge and expertise can create **innovation and efficiency**.

• The private sector often brings with it **greater construction capacity, labour capacity and resources** than would be available to the public sector.

• Payments to the private sector in PPP projects are usually linked to how they perform, creating **incentives** and efficiency.

• PPP projects are **not subject to political interference** and deferred payments for the government.

**Disadvantages**

• The number of parties involved and the long-term nature of their relationships often result in **complicated contracts** and **complex negotiations**, and therefore high transaction and legal costs. PPP projects can take years to complete.

• There is a risk that the private sector party will become insolvent or make large profits during the course of the project – this can cause **political problems** for the public entity.

• The long-term nature of a PPP project means that **debt is incurred long before the benefits appear**.

• Sometimes a public sector entity could **borrow more cheaply alone** than it could via the private sector. This has to be balanced against the fact that capital expenditure incurred by a public sector body counts as government expenditure which at certain stages of the economic cycle will score against the various statistical measures of government borrowing.

**DEVELOPMENT CASE STUDY**

Please refer to [http://www.ncppp.org/undp/cartagena.html](http://www.ncppp.org/undp/cartagena.html) for an example on how PPP can have a positive influence on development.