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Public-Private Partnerships: Unmasking the reality

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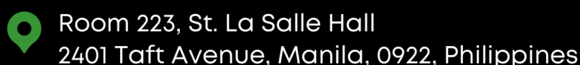
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Public-Private Partnerships: Unmasking the reality

By Jesus Felipe and Pedro Pascual

PUBLIC-PRIVATE Partnerships (PPPs) are long-term contractual arrangements where the private sector provides (builds and sometimes runs) infrastructure assets and services that have traditionally been directly funded by government, such as hospitals, schools, prisons, roads, bridges, tunnels, railways, and water and sanitation plants, and where there is also some form of risk sharing between the public and the private sector. These arrangements started in the 1990s in developed countries and now many developing countries are trying them.

In this Policy Brief, first we scrutinize the arguments to justify these contractual arrangements, and the available evidence about their proclaimed benefits. Then we discuss Philippine PPPs.

PPP advocates claim that these arrangements bring financing, efficiency, and innovation. They argue that by using private sector resources and expertise, PPPs have the potential to improve the quantity and quality of service delivery, thus creating better “value for money,” compared to traditional public procurement. These arrangements have increasingly been advertised as the magic solution to the many problems that developing countries face when building infrastructure. The argument also includes the questionable claim that the private sector is more efficient and better able to deliver public services, including energy, education, health, water and sanitation. Certainly, the private sector publicizes these arguments as PPPs open new business areas for some companies.

On these grounds, PPPs have become popular in developing countries, where people have been led to believe that their governments cannot undertake certain infrastructure projects because they do not have the capabilities (poor management and delivery) or because they lack the financial resources.

We read recently a report by the European Public Service Union and the European Network on Debt and Development that summarizes impeccably well the pitfalls of PPPs (*PPPs_EN.pdf, nationbuilder.com*).

Before getting into the pitfalls, it is important to further elaborate on why developing countries are buying into PPPs — they are bombarded. One reason is that international financial institutions (IFIs) are cheerleaders of these arrangements. Yet, PPPs are poor development advice with a clear political motivation: the privatization of public services. Their advice also comes from the perennial mantra that PPPs address the limited funding resources for local infrastructure or development projects of the public sector. However, sovereign governments like that of the Philippines do not have limited funding resources because these are set in the Peso, the national currency.

Also, developing countries have been duped and led to subscribe to the Sustainable Development Goals (SDGs) of the United Nations' Agenda 2030. This agenda has set targets for the developing countries in key areas such as infrastructure, health, education, water and sanitation, and gender equality, among others. Developing countries have been told that PPPs are needed to attain them. The problem with the SDGs is that they are no more than a long list of 250 targets that does not amount to development.

Likewise, the Paris Climate agreement requires urgent and immediate action to mitigate and adapt to climate change, particularly in areas such as infrastructure, food systems, and energy. Again, the private sector appears to be the solution.

Finally, the outbreak of COVID-19 has revealed the depth of the inequalities within and between countries, as the crisis induced by the pandemic takes its heaviest toll on the marginalized and most vulnerable communities. Governments across the globe agree about the need for massive investment. This is used as a fourth argument to justify PPPs.

As noted above, PPPs are supposed to solve financial constraints, poor management and delivery (know-how), in developing countries. The know-how problem might be true in very poor countries but this is a problem of both the public and the private sectors. If lack of Government know-how is a problem in a middle-income country like the Philippines (is it really?), the solution should be to expedite learning by the government to acquire the necessary capabilities to design and manage these projects, especially in areas such as education and health, which are the cornerstones of society's equality.

The financial constraint is an altogether different story. Many governments and international institutions argue that public resources and institutions have to be used to attract private finance to fill a perceived "financing gap." They have actively promoted PPPs all over the world. We said above that the problem with this argument is that a sovereign government (like that of the Philippines) that uses its own currency cannot have a financing gap.

The report we cite is based on the European experience. It provides plenty of evidence that questions the alleged benefits of PPPs. It draws on case studies across Europe that show that PPPs are proving to be poor value for money. This should be a warning sign for developing countries.

The report outlines the following reasons to question PPPs:

1. PPPs do not bring new money. In a PPP, the public sector does not take a loan to pay for a project. Instead, the private sector arranges the financing and builds the infrastructure. Then the public sector pays a set fee over the lifetime of the PPP contract (at times, users also pay part or all of the fee directly to the private sector company). Therefore, while PPPs might appear to raise new funds due to the private sector taking loans instead of the government, the funding for the project still comes from government budgets and/or end users. This is not noticed because PPP projects are usually recorded off the government's balance sheet, so they do not (misleadingly) impact on debt figures. Therefore, they create hidden debt.

2. Private finance costs more than government borrowing. The cost of private finance is higher than that of public borrowing. Both the OECD and IMF have warned that governments can nearly always raise capital at a lower cost than the private sector.

3. Public authorities still bear the ultimate risk of project failure. Proponents of PPPs argue that they are able to transfer project risks from the public to the private sector. However, public authorities still bear the ultimate risk of project failure. IFIs advise governments to guarantee profits for their private partners and urge governments to "de-risk" commercial providers to attract their investments.

4. There is a triad of bogus arguments often mentioned to support PPPs, namely that they offer better value for money, that they bring

efficiency gains, and that they are transparent. The reality is that PPPs don't guarantee better value for money, that efficiency gains and design innovation can result in corner-cutting, and that PPP deals are opaque and can contribute to corruption.

PPPs have rarely delivered better "value for money" than reasonably managed public projects. Likewise, PPP promoters argue that private sector companies introduce efficiency in the delivery of infrastructure and public services. Efficiency gains can come from improvements in design, construction, and operations. Yet, the theory is ambiguous and the empirical evidence is mixed. If there have been any efficiency gains, these have resulted from risky cost-cutting and a decline in service quality, e.g., in public infrastructure or healthcare provision. Also, many PPP deals are opaque and can contribute to corruption. Private companies often insist that many aspects of PPPs be kept secret, usually including the contracts themselves.

5. PPPs do not guarantee projects being on time or on budget. There is a general belief that private sector companies are better than the public sector at delivering projects on time and on budget. However, the evidence does not support this claim.

6. PPPs distort public policy priorities and force publicly run services to cut costs. PPPs have to be commercially viable, or private companies will not take part in them. This distorts policy decisions: some projects are not selected because they are not commercially viable; others are selected because they appear to be commercially viable; and some are adjusted to make them more attractive to the private sector, even if this means a decrease in the level of service.

This summary shows that PPPs come at a high cost and have not delivered the expected benefits. For this reason, developing countries ought to rethink the idea altogether. At least, government officials of developing countries need capacity-building to better manage PPPs, as well as the development of standardized contracts or other tools to help these contracts work more smoothly.

The Report makes two recommendations that we share: (i) halt PPPs in the social sectors, including health, education, and water; and, (ii) increase public investment in public services, to be financed by progressive taxation. This is the only way for citizens to get access to the high-quality

and universal public services they deserve. Having said this, we acknowledge that there might be room for the private sector to be involved in some public-sector projects but only when indeed there is a clear rationale for it, and avoiding the pitfalls we discussed above.

THE PHILIPPINES was one of the first countries in Southeast Asia to use Public-Private Partnerships (PPP) back in the late 1980s. "The indispensable role of the private sector" in the development of the country was anchored in the 1987 Constitution. President Corazon C. Aquino swiftly resorted to PPP schemes (Build-Operate-Transfer) to address the country's acute power shortage. It was indeed an urgent situation that needed immediate action, although looking back we realize that the country paid a high "rush fee": the government took the demand risk into a "take-or-pay" format, which resulted in one of the highest electricity rates in the region, which prevails up to today.

Throughout the 1990s, the Philippines became a "PPP champion" as private investments in infrastructure were even larger than investments undertaken by the public sector. At that time, this anomaly may have been regarded as a positive development that would bring efficiency to public services. In retrospective, this retreat of the public sector explains the infrastructure deficit that we are still suffering today.

Energy was the leading sector, followed by water (the Maynilad and Manila Water concessions for Metro Manila) and railway (MRT-3). In the mid-2000s, there was a rebound of PPPs (several power plants, PLDT, Transco). In the 2010s up to today, public investment outpaced private investment, more timidly in the first half (around 2% of GDP), and robustly since 2015 onwards (5-6% of GDP). Meanwhile, PPPs averaged 0.7% of GDP. The latest available figures for Private Participation in Infrastructure from the World Bank (first half of 2023) rank the Philippines as the second largest investor among low- and middle-income countries (MRT-7 explains a significant portion).

The "surrender" of essential infrastructure investment to the private sector, mostly during the 1990s and early 2000s, has positioned the Philippines as the second largest developer of PPPs in ASEAN (second to Malaysia), with a capital stock as percentage of GDP of 7%.

PPP IN THE BUILD, BETTER, MORE AGENDA

After the "all-PPP" and "no-PPP" phases, it seems we are now entering into a more balanced approach to this reality, which is good news. The Marcos Jr. administration wants PPPs to play a larger role in its infra investment agenda, "in light of the tighter fiscal space." A substantial improvement in the regulatory framework of PPPs shall be credited to this Administration, since it addressed the Material Adverse Government Action (MAGA) issue right after taking office, and by passing a unified PPP Code recently.

However, we do not agree with the rationale that anchors this change in policy. Whereas the country's public debt/GDP ratio is higher today than before the pandemic (60% vs. 40%), it is not true that the State has to undertake a fiscal consolidation and is therefore "forced" to resort to the private sector to undertake its infra-agenda through PPPs. We argued in the first part of this article (See Public-Private Partnerships: Unmasking the reality – BusinessWorld Online (bworldonline.com)) that sovereign governments like that of the Philippines do not have limited funding resources.

What is the current PPP portfolio and how is it going to support the Build, Better, More program? According to the PPP Center (https://ppp.gov.ph/ppp-program/what-is-ppp/), there are 116 projects in the pipeline with an estimated project cost of P2.4 trillion ($48.3 billion). Out of these, most are at the national level (80%, 94% of the total value), unsolicited (41%, 80% of the total value) and at a very early stage of development. If we look at the latest Infrastructure Flagship Project List compiled by the National Economic and Development Authority (NEDA), 25% of the projects and investment is targeted for PPPs (50% through Official Development Assistance, 17% through Government Appropriations Act), belonging most of them to the Departments of Transportation (Railways, Airports) followed by Public Works and Highways (Tollways).

AIRPORTS

The "PPP of the year" — and most probably of this administration — has been the concession of the Ninoy Aquino International Airport or NAIA to San Miguel Corp. for 15 years. Despite our reservations about how the bid was structured — rewarding the largest government share instead of the largest investment in the facilities — we agree private participation in airport operation has been mostly successful here and abroad. Nevertheless, the largest airport operator in the world (AENA in Spain) is a state-owned company at par with the best airports in the world, proving

that it is perfectly possible for the Government to retain the provision of these services.

RAILWAYS

One of the most controversial historic PPP projects is actually in railways, the MRT-3. While acknowledging the critical importance of this project for Metro Manila connectivity, it has been extremely disadvantageous for the State, and ultimately for the taxpayer.

The project reached financial closing in 1997 and was designed as a Build-Lease-Transfer, with the Department of Transportation retaining the operation of the line. The total project cost amounted to $675.5 million (equivalent to $2 billion today) and was awarded to the Metro Rail Transit Corp. (MRTC). This private consortium provided 29% of the total project cost in equity while the rest (71%) was secured through several Official Development Assistance loans. The government bore the whole demand risk, agreeing to provide the consortium an annual lease plus a 15% annual return on equity capital (in US dollars!).

No complex calculations are needed to conclude that the Filipino taxpayer would have paid a much lower price for this project through a non-PPP scheme (just for reference, the US dollar one-year-LIBOR stood at 6% in 1997, peaking at 7.5% in 2000, and below 2% in the aftermath of the great financial crisis).

What is the risk that the government transferred to the private consortium that was so highly priced? None! Why was the equity and secured annual return in US dollars when construction costs are mostly in Pesos? The only good news is that the lease agreement will end in 2025.

We are convinced that such an agreement would not happen today. Nevertheless, we have reasonable concerns about the shift to PPP of railway projects that were initially supposed to be financed through Official Development Assistance and/or the Government Appropriations Act.

TOLLWAYS

It is one of the most active sectors for PPP schemes in the Philippines, and the prospects are bright in the light of the solid economic growth and rising purchasing power in the National Capital Region and surrounding regions. The established operators — San Miguel and Metro Pacific — have a sound understanding of the business model and keep submitting unsolicited

proposals for new projects. However, if the announced merger finally materializes, it will jeopardize the already weak competition in the market: from a duopoly to monopoly.

A pending issue for the government is to extend expressways beyond financially profitable projects, as it is a critical element of territorial cohesion. Would, in that case, PPPs be the most efficient option? We doubt it.

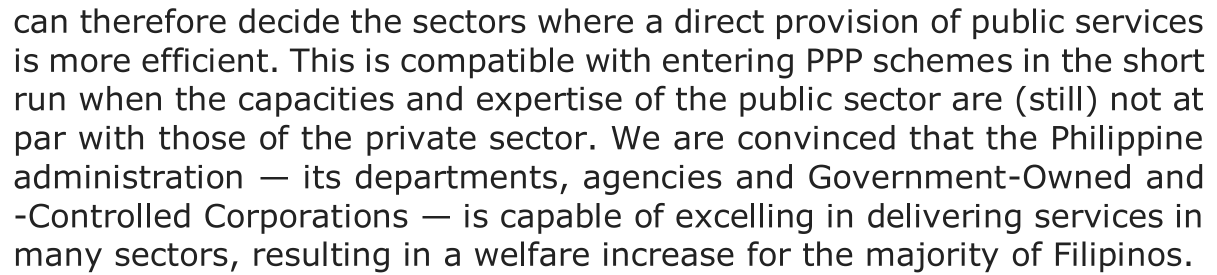
ALLOCATING RISK EFFICIENTLY

What should ideally trigger a PPP? It is fundamentally a matter of allocating risk efficiently, assessing what entity is in a better position to assume certain risks. In addition, for a PPP to fly the different elements of the scheme shall make the project bankable. PPPs are not just an alternative when fiscal space is tight, although it has been widely used and even recommended by international financial institutions as such. Even in an economy with 0% Public Debt/GDP and fiscal surplus, there is room for PPPs.

Another issue that should be considered is the real level of independence of economic managers from powerful corporations. This is relevant during PPP assessment and award and throughout the project's life, particularly when fares are revised. The Philippines has a very oligopolistic political and economic structure, with both strongly intertwined (https://jesusfelipe.net/wp-content/uploads/2023/08/DLSU-AKI-Working-Paper-Series-2023-07-087.pdf). Despite the substantial liberalization derived from the Public Service Act of 2021, there is (still) no real foreign competition in most PPP prone sectors.

Nevertheless, we acknowledge that PPPs may be the least bad solutions during certain crises. Here we can recall the economically disadvantageous PPP entered in power generation in the early 1990s. Despite the fact that no one could defend these PPPs as being ideal (very poor value for money), the power crisis was tackled. The Philippines is today by no means even remotely close to a situation that would justify that kind of "emergency PPP" to safeguard the provision of public services.

Finally, we would like to stress the importance of having a long-term strategy on private participation in infrastructure projects. As we have argued, there is no consistent evidence of better performance by the private sector in the provision of certain public services. The government



can therefore decide the sectors where a direct provision of public services is more efficient. This is compatible with entering PPP schemes in the short run when the capacities and expertise of the public sector are (still) not at par with those of the private sector. We are convinced that the Philippine administration — its departments, agencies and Government-Owned and -Controlled Corporations — is capable of excelling in delivering services in many sectors, resulting in a welfare increase for the majority of Filipinos.