Public Infrastructure Bulletin

Volume 1 | Issue 2 Article 4

9-1-2003

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Darrin Grimsey

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Recommended Citation

Grimsey, Darrin (2003) "The privatisation myth," *Public Infrastructure Bulletin*: Vol. 1 : Iss. 2 , Article 4.
Available at: http://epublications.bond.edu.au/pib/vol1/iss2/4

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THE PRIVATISATION MYTH

Debate about PPPs often lumps them with privatisations and suggests that private finance is more expensive than traditional procurement methods. Darrin Grimsey of PricewaterhouseCoopers argues that economic facts show both objections are simply wrong.

How many times has the UK's failed privatisation of the rail infrastructure (Railtrack) been cited as an example of a flawed PPP? Privatisation is a term that can engender ideological opposition and in particular from the left side of politics and the concepts of privatisation, Public Private Partnerships (PPPs) and even relatively straightforward contracting out of services are often used synonymously.

THE DIFFERENCE BETWEEN PRIVATISATION AND PPPS

In Australia and the UK, privatisation has traditionally and rather simply referred to the transfer of physical assets from public to private ownership. The sale of a public utility via a share float constitutes straightforward privatisation in these terms. In contrast Michael Gerrard[1], from Partnerships UK, defines PPPs as arrangements that 'combine the deployment of private sector capital and, sometimes, public sector capital to improve public services or the management of public sector assets.' Gerrard's PPP agenda includes the management of existing public assets as well as the construction of new infrastructure. Previously, PPPs were thought of mainly as vehicles for the provision of new public sector facilities through which services are provided to the public.

This change of emphasis complicates the question of whether, and how, PPPs differ from privatisation. One reason is that within a PPP the public sector acquires and pays for services from the private sector on behalf of the community. It retains ultimate responsibility for the delivery of the services, albeit that they are being provided by the private sector over an extended period of time (often 25 years or longer). By contrast when a government entity is privatised, the private firm that takes over the business also assumes the responsibility for service delivery.

In the latter case, it would be wrong to say that the government is indifferent to the quality of services provided by the newly privatised entity. Rather two other mechanisms come into play. The private firm is subject to disciplines from both product and capital markets in the form of competition from other firms and competition when raising finance. If these market constraints do not exist effectively, perhaps because the privatised firm has some form of natural monopoly, then the government would usually impose some type of regulatory regime. This is typically over price or rate of return.

MARKET FORCES VS. THE CONTRACT INSTRUMENT

In this case, however, the regulation is quite different from that under a PPP. This difference is the principal reason why PPPs are not privatisation even if they include the management of existing assets.

A PPP is a formal business arrangement between the public and private sectors. The nature of this business activity, the outcomes required, the prices paid for the services (and thus the scope for profits) along with the general rights and obligations of the various parties are specified in considerable detail in the concession agreement. Consequently, regulation does not come from some statutory regulatory agency or from unseen market forces. It is a direct result of an explicit contract subject to performance indicators and quality standards, with penalties attached to failure to maintain service standards on a continuing basis.

The distinctive feature of PPP is this element of *ex-ante* competition; competition for the market as opposed to competition in it. The market in this case is defined by the contract specification, and the bidding process resembles an auction. A formal contract binds the parties to an exchange of services of a pre-determined quality and quantity for agreed financial payments. The contract itself becomes the instrument through which relations between the parties are

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Published by ePublications@bond, 2003

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managed and regulated. This is the fundamental reason PPPs are not the same as privatisation.

THE VALUE FOR MONEY QUESTION

If we accept that PPPs are just another form of public procurement the next question is whether or not they represent good value for money.

PPPs often differ from traditional public procurement by virtue of the requirement that the private sector finance the projects. Given that the extra cost of private sector funding vis-à-vis public borrowing is likely to be between one and three percentage points, some have argued that PPPs can never be good value for money. Others, while accepting that they can be value for money because the private sector is able to deliver cost savings in other aspects of the project (design, operation, management), nevertheless concede that private borrowing costs are higher.

Grout and Klein[2] question this proposition. Both conclude that the 'lower government borrowing cost' argument is seriously flawed. Their argument is in some ways analogous to the famous Modigliani-Miller theorem about the cost of capital. Modigliani and Miller argued that the 'true' value of a firm was independent of how finance was raised and, thus, the capital structure of the enterprise. Grout and also Klein argue that what is important is the 'true' risk of the project, which is independent of whether the public sector provides the funding. What differs is that the private provision of finance—the PPP route—explicitly builds the risk into the cost of funds. By contrast, the traditional public procurement process masks the risk; the government can fund the project at a risk-free rate independent of the actual risk position. As John Kay has remarked: 'we would lend to the government even if we thought it would burn the money or fire it off into space.'[3]

FACTORING RISK INTO THE COST OF FUNDS

But why can government borrow at a risk-free rate of interest? This reflects that (again quoting John Kay) "the cost of debt both to governments and to private firms is influenced predominately by the perceived risk of default rather than an assessment of the quality of returns from the specific investment." For private debt there is a risk of default. For government debt, there is little or none because the government can raise the taxes to meet the obligation. The government is risk-free in the eyes of the investor lending funds because the risk is transferred to the taxpayers, who bear the cost through the risk of higher future tax payments and different consumption outcomes.

Federation Square is a example where the huge cost overruns from the project fall back on Victoria's tax payers, not investors in government bonds! In Klein's words, taxpayers have assumed a contingent liability for which they are not remunerated. This residual risk imposed upon taxpayers is a cost, which ought to enter into any cost-benefit analysis. If this were done, the real cost of government borrowing would be the same as the private sector, if the underlying risk of the projects were the same.

The logical conclusion from this argument is that the cost of funds is irrelevant to whether or not PPPs are more or less expensive than traditional procurement. The real question should be whether a PPP approach to procurement is likely to deliver value for money benefits to government. This question can only be answered by looking at the scope for the private sector to bring innovation, lower risk pricing and cost efficiencies through a well managed and rigorous procurement process.

HIDING GOVERNMENT COST OVERRUNS

Substantial evidence has emerged since the mid 1980s, and is surveyed by Domberger and Rimmer[4], which suggests that governments can save in the order of 20 per cent of expenditures on services by putting them through a competitive tendering process. Empirical evidence also suggests that governments around the world that have embraced PPPs are reaping the rewards of their efforts. Evidence is emerging from reliable sources that there is value for money and more importantly that service delivery is improving.

The National Audit Office in the UK, for example, often reports on the UK's Private Finance Initiative including value for money gains as compared to the Public Sector Comparator (PSC). In the case of PPPs in general, the National Audit Office has produced value for money reports on 15 projects, seven of which (including a hospital project) were evaluated against a PSC. On average, the cost saving was 20 per cent.[5]

Faced with this evidence the PPP sceptics look for conspiracy and claim distortion in the compilation of the PSC. They also call for more tangible evidence. This, of course, is difficult to provide given that virtually every infrastructure project is one-off and therefore true comparison between procurement options is impossible. It is interesting to note that very few commentators call for the same type of value for money rigour or indeed public policy debate on traditional forms of procurement. Yet it is cost overruns on projects like Federation Square that have to be picked up by unsuspecting tax payers.

REFORMING THE PUBLIC SECTOR

Why has PPP policy gained currency as an instrument of public-sector reform? It achieves better value for taxpayers' money, but because of their wider scope and sophistication, PPPs also introduce many more elements into the equation. The nature of a public-private partnership means a change in the way government interacts with the private sector. PPPs can introduce change (and by implication value) into the public sector in six key areas.

1. Management reform

PPPs can alter the way government functions by introducing market disciplines into public services.

2. Encouraging problem conversion

The task for public sector managers becomes one of re-framing constraints they face so as to facilitate the entry of private sector operators and their commitment of funds. The focus becomes one of the outcomes to be achieved, rather than the processes by which things are done.

3. 'Moral regeneration'

PPPs can widen the number of stakeholders in the outcomes and building market experience for public service managers.

4. Risk reallocation

PPPs allow for financial risks to be shifted from public to private investors.

5. Restructuring public services

Partnerships can be a vehicle for restructuring public services, streamlining administrative procedures and substituting a private workplace for public servants.

6. Improving business-government relations

As power sharing arrangements, PPPs can alter business-government relations in fundamental ways. One is that an ethos of cooperation and trust can replace the adversarial relations endemic to command-and-control regulation. Also, any relationship between partners will involve some mutually beneficial sharing of responsibility, knowledge or risk. In most instances, each party brings something of value to the others to be invested or exchanged. Finally, there is an expectation of give-and-take between the partners, negotiating differences that were otherwise litigated. This is the essence of partnering.

Source: Linder[6]

...very few commentators call for the same type of value for money rigour or indeed public policy debate on traditional forms of procurement.

PPPs are not an expensive form of privatisation and can introduce real benefits into the public sector. Faced with the economic facts it is worth questioning the real motives of those that claim that PPPs are just expensive privatisation. What are they really afraid of?

Darrin Grimsey is the Director of the Project Finance and Investment Banking team at PricewaterhouseCoopers. He has 15 years experience working in the projects environment as an engineer, project manager and financial adviser, including advising on Private Finance Initiative (PFI) projects in the UK. His expertise in the delivery of infrastructure projects led to his secondment for a year to the Office of the Victorian Treasurer as financial/commercial policy adviser. Darrin's work culminated in the release of the Victorian Government's *Partnerships Victoria* policy. Since then, he has advised both the Victorian and South Australian governments on a number of PPP projects.
Email: darrin.grimsey@au.pwcglobal.com

1 M.B. Gerrard, 'Public-Private Partnerships', *Finance and Development*, 38 (3), 2001, pp 48-51.

2 P. Grout, 'The Economics of the Private Finance Initiative', *Oxford Review of Economic Policy*, 13 (4), 1997, pp 53-66. M. Klein, 'The risk premium for evaluating public projects', *Oxford Review of Economic Policy*, 13 (4), 1997, pp 29-42.

3 Cited in Klein, p63, see note 2. J. Kay, 'Efficiency and Private Capital in the Provision of Infrastructure,' in *Infrastructure Policies for the 1990s*, Organisation for Economic Co-operation and Development, Paris, 1993, pp 55-73.

4 S. Domberger and S. Rimmer, 'Competitive Tendering and Contracting in the Public Sector: A Survey', *International Journal of the Economics of Business*,1 (3), 1994, pp 439-453.

5 National Audit Office, NAO Value for Money Reports on PPP/PFI, 2001, <www.nao.gov.uk./publications/vfmsublist/vfm_ppp.htm>

6 S.H. Linder, 'Coming to Terms With the Public-Private Partnership', *American Behavioural Scientist*, 43 (1), 1999, pp 35-51.