

III Forum on Competition and Regulation

Public Private Partnerships, betting on the "third way" With Eduardo Engel, University of Yale

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Public Provision and Privatization (PPP) have shown to have several disadvantages when applied to the development of infrastructures. The possibility of uniting the benefits of each system is the idea of concessions, an increasingly common practice worldwide. One of the main positive aspects of this formula is the possibility of sharing risks that a private company can't assume on its own and it also helps governments to be able to develop large infrastructure projects that would otherwise be unachievable.

How to do it better?, this question was the core element of Eduardo Engel's speech. Engel, a professor at Yale University, visited IESE Business School to take part in the forum organized by the [Public-Private Sector Research Centre](#).

After analyzing both models and their characteristics, advantages and disadvantages, he tried analyzing the best way of implementing Public Private Partnerships as an advisable way to develop infrastructures in countries, specially centring his examples on road building.

COMBINING ADVANTAGES

Eduardo Engel (picture) began his lecture approaching some of the main characteristics of the public and private options to try and find some of the features that define and identify their main strengths and weaknesses.



Regarding public provision he referred to the fact that history shows that traditional models of public provision, very popular a few decades ago, during the 80's, had several common problems such as time and costs overruns as well as the fact that many times the designs are over engineered because public sectors find in infrastructures a demonstration of the strength and well-being of governments, this leads to constructions that can be way too ambitious or with large dimensions in relation to the real needs.

When analyzing private participation he stated the difficulties to justify them because of the need to relieve strained public budgets but that private participation is warranted in PPP's when the private firm can show that the productive efficiency is higher. Another important element is that in private provision the assets are of the firm whereas in a PPP system the assets will go back to the state.

These are only some of the aspects that Engel approached and then he developed the idea that the junction between the private and the public sector is a good way of achieving a better development. By combining the best aspects of each, both sides get a positive result, especially because the main goal is to distribute risks and this is the way to do so, as Engel explains.

In almost any construction of this dimension, a private company can't face the risks and this is precisely one of the main reasons why there is benefit in the PPP option, because it makes both parts residual claimants in the different risks of the project such as construction, maintenance or demand.

Some other of the arguments that favour relying on private firms to create a PPP is the fact that companies usually are faster at building, less bureaucratic besides the advantage that capital markets impose discipline.



POSITIVE BUNDLING

Another of the positive aspects talked about during the lecture was bundle building, because if construction and maintenance are entrusted in one same firm this can have positive results because the company will want to establish a good system that will make its maintenance easier in the future.

Many times governments are using PPP formulas as a way of guaranteeing constructions that otherwise would be unachievable by public funds. In the forum established after the presentation, Manel Nadal, Secretary of Mobility of the Catalan government and moderator in the forum, reinforced the idea by explaining that governments consider the PPP option because they want to develop projects 'here and now'. "Building infrastructures is a way of not losing competitiveness and that is why we can't wait to have the necessary resources and we rely on partnerships".

Another of the reasons why many consider PPP a positive move on economics is because it breaks the monopoly and allows many private firms to compete for the concession. In this sense competitive markets are established in construction and this translates into benefits and makes infrastructure projects often to have market power.

On the other hand some political issues are involved because when the infrastructure is done with public provision, the government can be tempted to reduce fees and tolls as a way to gain political popularity at some stage. In this sense, Engel stated that using the PPP formula makes it easier to charge tolls closer to marginal costs. Also, by throwing a competitive auction this function as a market test to screen for white elephants.

But Engel also pointed out some aspects that should be consider in order for PPP to be worthwhile, such as the fact that high contracting costs justify PPP only in big investments, or that second best pricing induces distortions because it's difficult to be able to set a price equal to marginal costs.

Although some benefits can be found in full privatization, for example larger efficiency gains or that it's a way to avoid the lack of incentives to exert effort toward the end of the contract or that the relation with the budget is permanently severed; PPP facilitate adaptive decisions.

VARIABLE TERM CONTRACTS

The contract is one of the aspects the professor referred to and he stated that fixed-term concessions are inappropriate and the best option is to choose variable term concessions.

It is important as well to consider incentives in order to build the infrastructure on time and to assure maintenance and service towards the end of the contract.

A variable term contract has the characteristic that the firms bid or negotiate the present value of user-fee revenue they want to collect from users. The contract is awarded to the lowest bid and it lasts until the firm collects revenue equal to its winning bid.

This is a good model because the contract length is directly related to the use the infrastructure gets, which means that if the demand is low the contact will extend and if it's higher it gets shortened. This system guarantees that if the concession lasts long enough eventually the project will be profitable.

Despite these advantages Present-Value-of-Revenue (PVR) contracts haven't been very popular, in Engels opinion, because firms find it difficult to renegotiate besides concessionaires don't like them, but for the fiscal authority it's positive because it avoids government guarantees.

About the impact on government budgets, Eduardo Engel stated that "Then public provision and PPP have the same intertemporal impact on the government budget" because as he explains "the future revenue lost by ceding income flows to the private sector exactly offsets the investment savings made by the government early on in the relationship".

In the contract it is also a tendency to try and renegotiate, something that Manel Nadal explains can be positive for companies because it tends to delay the investment.

About renovations, Nadal said that the difficult aspects are "how to guarantee that the renovation means an improvement for the infrastructure and the public sector". But renegotiation is a key element and it should be done in advance "if there isn't a previous renegotiation years in advance it tends towards a brutal deterioration" the immediately previous years before the concession ends.



From the left to the right: Manel Nadal (Secretary of Mobility, Generalitat de Catalunya), Prof. Eduardo Engel (Professor of Economics, University of Yale) and Prof. Xavier Vives (Academic Director, Public-Private Research Center, IESE Business School).

THE FUTURE OF PPP

When analyzing the conclusions, Engel defines PPP as large upfront investments combined with long-lived assets. When referring to assets he insists that PPP assets should be counted as public.

An outstanding aspect are economic characteristics such as low operation and maintenance costs or the possibility of lowering other spending with initiatives such as electronic tolls.

A feature that Engel considers important is the fact that in the PPP agreement the agency may plan and procure but that social cost-benefits appraisals should be performed or at least evaluated by an independent agency.

Engel referred to PPP by stating that they are "here to stay" and they are as well "likely to become increasingly important in many countries". In the near future he believes that major improvements in contract design and auction mechanism will also occur because countries that have begun using the PPP's formula are now learning from what went wrong and can undertake second wave of these type of contracts from an improved point of view.