PUBLIC-PRIVATE PARTNERSHIPS

THE CARROT AND STICK APPROACH

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History suggests that there is no ideal model for providing essential public services. However, public-private partnerships can offer enhanced efficiency while remaining accountable to the public body.

PUBLIC-PRIVATE PARTNERSHIPS • UTILITIES MONOPOLIES • OPTION CONTRACTS

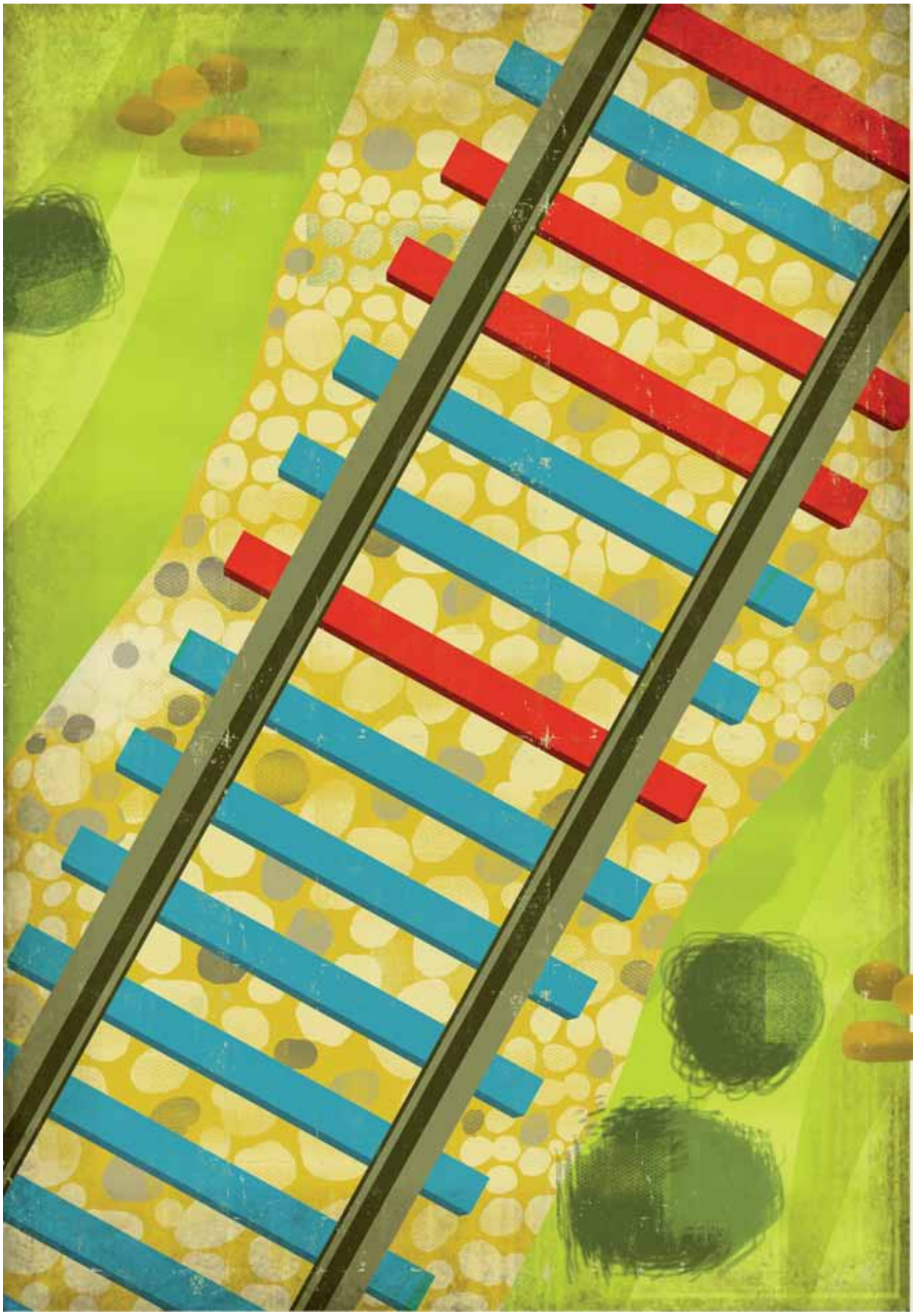
It has long been accepted that essential services such as water, energy and public transportation cannot be left to the mercy of market forces. However, the manner of financing and providing public utilities has changed considerably over the years. Originally, all utilities companies were private. There was little technical cohesion – rail gauges, for example, were not standardized – and prices were not in range of everyone's pocket.

As the government grew stronger, it began to assume more prerogatives, especially after the 1930s' recession. There was also a widespread belief that it was in the broader social interest to offer universal access to essential services such as water and public transport. This was only possible through providing large government subsidies or owning the utilities. By the mid-20th century, throughout Europe and many other parts of the world, virtually all public services were government-run.

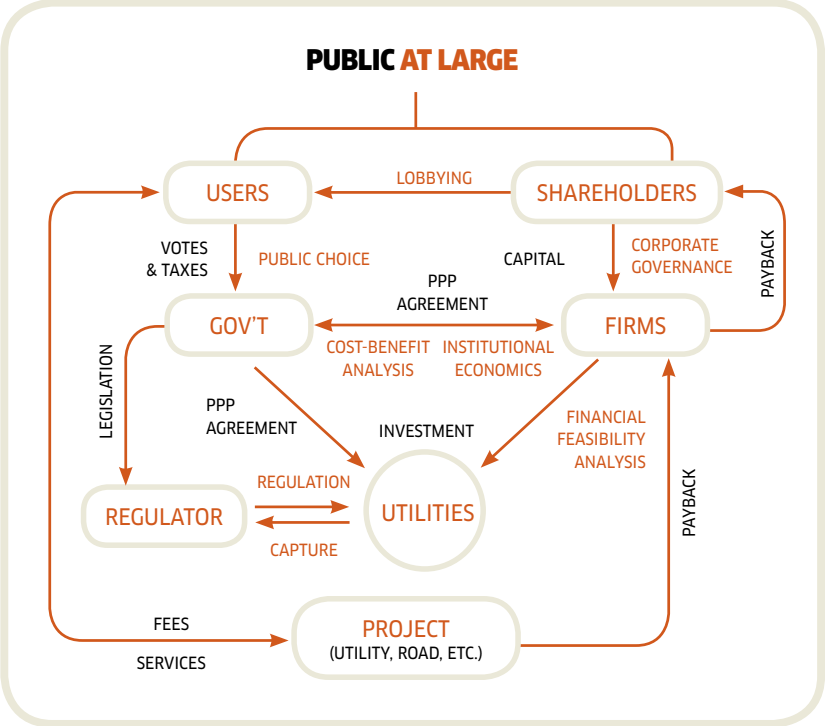
But by the 1980s Western states faced large deficits and financial constraints. This was a new phenomenon. Before that, the government had deep pockets. It could print money and raise taxes and didn't have debt problems. Now corporations had grown and it was private capital that had the deep pockets and, furthermore, the technological and managerial advantage. There was also an ideological dimension in the switch to the private sector that was rooted in a different understanding of the function of the state - while the state was responsible for the provision of public services, it didn't have to own and operate the assets.

The private sector was seen as a more efficient public services provider. Studies in the United Kingdom and the United States show that the private sector can deliver infrastructure and operate it 15–30 percent cheaper than the public sector, thanks mainly to more efficient management and lower administrative costs.

Nobel laureate economist **Milton Friedman** said that "[w]hen technical conditions make a monopoly the natural outcome of competitive market forces, there are only three alternatives that seem available: private monopoly, public monopoly, or public regulation. All three are bad so we must choose among evils" (*Capitalism and Freedom*, 1962). In other words, the private monopolist can raise prices and lower quality because there is no competition. Prices and quality can be set by a regulatory agency; regulation, however, is costly due to information asymmetry between the



IF EITHER PARTY IS IMPATIENT, THERE IS A GREATER LIKELIHOOD OF OPPORTUNISM.



regulator and the provider. Finally, public monopoly is bad because of the inefficiencies of the state. One could argue that Friedman was partially right: there is in fact a fourth way, which is also bad, to organize natural monopolies in the utilities sector: public-private partnerships (PPP). The question is not so much which is the best, but which is the least inefficient.

We should distinguish between one-off private contracts for public works and PPPs that involve long-term contracts in which risks and benefits are shared. The share of risks is a key component of a PPP. Some risks are better borne by the investor, for example, construction risk, while others - for example, force majeure or political risks - by the public body. The terms of PPP contracts are vital for creating mutual incentives - the carrots and the sticks.

In general, PPPs are most efficient in countries whose governments pursue stability-oriented and predictable macroeconomic policies that are conducive to securing cheaper financing. An equally important prerequisite is a reliable legal system that provides the instruments to secure the interest of the public body and the private investor vis-à-vis each other. It is also vital that the partners trust one another. If any or all of these conditions are violated, the possible savings achieved with the PPP scheme diminish.

The profile of the private partner in a PPP is an industry investor, that is, someone who has been in the field a long time and has the managerial and technological edge. The large British and French water companies, for example, run water companies all over the world. Investment funds are also attracted to this type of investments as a means of diversifying and lowering the volatility of their portfolios. You won't make a killing, but you know that people are going to go on using water, electricity and public transport. As an asset class, PPPs offer the investor a decent and stable profit over the long term, i.e., market return at fairly low risk.

If either political appointees or the investor are impatient, there is a greater likelihood of opportunism and deviation from the contract. For example, to gain popularity the public agent can be opportunistic by changing the rules of the game, for

example, by capping prices of public services or imposing higher standards that require additional expenditures after sunk investments have been made, presenting the investor with a take-it-or-leave-it situation.

On the other hand, the private company may lower the standards of the infrastructure it is contracted to install, knowing it can't all be checked. Likewise, the investor may have opportunistically put in an unrealistically low tender in order to win the contract and then stage a hold-up once the work is under way. Low bids aimed at renegotiation typically happen with contracts for big sporting events where the private contractor can hold a gun to the client's head, knowing the public body has an immutable deadline. This has already occurred with some infrastructure contracts for the Euro 2012 football championships that are to be held in Poland and Ukraine. In any of these cases, the government may retaliate by expropriating the investment but, as the saying goes, it's never a good idea to change horses in mid-stream. It can also prove expensive.

It is not advisable to pursue PPP agreements if the government's aim is to cover budget deficits. It implies that the government is only interested in the investor's money, not their expertise and, once financial constraints disappear, the government may breach its commitments. Marrying for money only works in the short term. In a PPP you have to look for long-term complementarities.

When assessing the feasibility of a PPP project, the public entity also has to take into account not only the financial cash flows, but also the externalities generated by the investment and discount them at the "social discount rate." For example, in a PPP to build a stretch of highway, the investor is interested in the tolls that can be collected while, for the public entity, the road may help to develop the local economy, lower congestion, or may be safer than the old road. On the other hand, there may be negative externalities as well, such as pollution or other irreversible environmental damage. An exhaustive benefits and cost analysis may show whether it is efficient to subsidize a PPP project even if the financial net present value of the investment is negative. In general, the state has to take a longer-term and broader view than private capital.

There is an inherent conflict of interest in a PPP in that the investor is primarily interested in profit, whereas the government's overriding concern should be for consumer satisfaction based on quality and accessible prices. The key to resolving this conflict and avoiding a double hold-up problem is to provide incentives to avoid opportunism. The investor doesn't want to be expropriated and the public entity doesn't want to be accused of providing the public with sub-standard service.

It all comes down to giving both sides the incentive and the assurance they need so that they don't fear the actions of the other. This can be achieved by over-the-counter option contracts - analogous to financial options - that combine the stability of long-term contracts and the flexibility of short-term contracts. The investor is given an exit option (similar to a put option) and the government a bail-out option (similar to a call option) on the private investor's shares in the utilities company, creating a sort of balance of deterrents: the investor can get out and cover their bottom line, while the public body can get rid of the investor if a party feels the other party is not keeping his or her side of the bargain.

With the exit/bail-out option mechanism, information asymmetries (for example, on quality or accounting) are less likely to occur, since deviation is punished in the subsequent period. Incentives for long-term investments are at the same time risk deterrents of opportunism. The flexibility of the option contracts enables a continuous process of enhancing cooperation between the investor and the public agent, or termination of cooperation without loss for any of the parties.

PPPS ARE MOST EFFICIENT IN COUNTRIES WHOSE GOVERNMENTS PURSUE STABILITY-ORIENTED AND PREDICTABLE MACRO-ECONOMIC POLICIES THAT ARE CONDUCIVE TO SECURING CHEAPER FINANCING.