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IMPLEMENTING PUBLIC-PRIVATE PARTNERSHIPS IN MUNICIPALITIES

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Abstract

Public-Private Partnerships (PPPs) realize three critical strategic issues for improving the quality of urban services: the enhancement of governmental financing capabilities, the improvement of public investment efficiency, and the harnessing of consumer-orientated management expertise. Based on a sample of 20 projects embarked upon by the city of Warsaw, we examine the process of project selection and planning and the prerequisites for satisfactory completion. The paper contributes to the literature on the PPP pre-implementation process and offers a perspective on the potential of PPPs in emerging economies. Key policy recommendations are (1) central headquarters for coordination of planning processes, (2) clear project selection criteria, (3) involvement of independent consulting companies to legitimate the process to subsequent administrations, (4) ex ante risk allocation and ex post performance measurement procedures, (5) pre-determined termination conditions, (6) commitment to starting the process and learning by doing; and (7) knowledge transfer and retention mechanisms.

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IMPLEMENTING PUBLIC-PRIVATE PARTNERSHIPS IN MUNICIPALITIES

Public-Private Partnerships (PPPs), long-term cooperation agreements between a public authority and the private sector to provide public services, have become a popular approach to infrastructure development. Since the mid-1980s, the notion of partnership in urban renewal and development has attracted considerable discourse in Western countries,[1] but the discussions on public management have tended to be polarized and both advocates and opponents of private sector involvement in the provision of public services have emerged (Grimshaw et al., 2001; Ghere, 2001). Despite the controversies over PPP, the United Nations and the European Commission have promoted and fostered it as an instrument for urban development,[2] especially in countries whose public budgets cannot support substantial expenditures (see, for example, Chang et al., 2003). Using a flagship PPP program undertaken by the city of Warsaw, this case-based paper offers a pragmatic view of the critical stages of PPP planning and adds to the literature about PPPs' prerequisites for success.

Public projects in Central and Eastern Europe (CEE) have traditionally been financed with public money and have produced poor infrastructure, which has led to unsatisfactory quality of public services. Public pressure motivates administrations to look for alternative methods of procuring and operating infrastructure-related projects, and urban projects make up a significant percentage of these projects.

There are three critical strategic issues related to improving urban infrastructure in emerging economies: 1) the enhancement of governmental financing capabilities through the mobilization of private-sector funds, 2) the improvement of public investment efficiency, and 3) the harnessing of consumer-orientated management. PPPs are emerging as one of the most viable and efficient methods for addressing these issues. Local governments in emerging economies in CEE have been slow to make the transition from traditional methods of public service delivery to internationally proven alternative approaches largely because of the considerable mistrust and confusion that persists about the nature of PPPs and the limited experience in this field. The extent to which PPPs are used in Poland is very small in comparison to developed countries, with projects working in only three out of the eleven

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[1] A landmark book was published by Brooks et al. (1984).

[2] Two examples are the Public-Private Partnerships for Urban Development, a United Nations Development Programme initiative to alleviate poverty through public-private partnerships in poor cities throughout the developing world (see http://pppue.undp.org), and the European Commission's manual, "Guidelines for Successful Public-Private Partnership."

sectors listed by the European Investment Bank (European Investment Bank, 2004; Bondal, 2005).

Considerable literature has been devoted to the efficiency of PPPs (see, for example, Vaillancourt-Rosenau, 2000; Moszoro, 2010) and particular case studies.[3] However, the literature on the pre-implementation process of dealing with PPPs, which is fundamental to the success of the whole process, is modest, although a notable exception is Grimsey and Lewis (2004). We trace the processes upon which the city of Warsaw has embarked in order to determine how to engage the private sector in PPPs for the benefit of society. The article reviews the background of twenty flagship projects, describes the processes undertaken to select and plan them, and draws conclusions concerning prerequisites for satisfactory completion. The article also presents the strengths of PPPs in terms of bringing together multiple stakeholders and distributing risk among them, the benefits of engaging external advisers, and the necessity of establishing quality performance measurements and termination conditions in the contract. In so doing, it offers an important perspective on the potential of PPPs in emerging economies as an effective mechanism with which to develop infrastructure and improve the quality of public services. Given that Warsaw is the largest city in CEE and perhaps one of the most complex, the conclusions drawn from its ongoing process of urban PPP implementation will be profoundly important for similar efforts being made by beginners in this field.

1. Analytical Model of Public-Private Relationships

National, regional, and municipal governments must be aware of the expectations of the society they serve. Public projects (for example, public utilities, roads, and schools) must deliver a service at a certain expected level of quality, but if they involve private investors, they must also meet the expected financial payback from the invested capital.

Public agents can control the service provider directly through a having stake in the project (usually a Special Purpose Vehicle, or SPV) or indirectly through regulation (price caps and quality controls). In the last decade, emphasis has shifted from the former to the latter (Newbery, 2000). However, governments must safeguard themselves against the risk of being "captured" by private investors (Viscusi, Vernon and Harrington, 2000),[4] so governments should set ex ante clear and unambiguous objectives in order to prevent public projects from being dominated by the for-profit corporate governance of the private partner (Heinz 2005). The best tool with which to protect the interest of the government and the final users it represents is a properly negotiated contract, that is, a contract that spells out and minimizes risks for both parties.

According to the European System of Accounts, PPP risks can be classified into three broad categories: construction risk, availability risk, and demand risk (Bondal, 2005). Construction risk covers events such as late delivery, costs overages, and technical deficiency. Availability risk refers to the private contractor's failure to deliver the agreed volume and/or quality or her failure to meet specified safety or public certification standards. Demand risk refers to the

[3] Two rich databases of PPP projects can be found at:

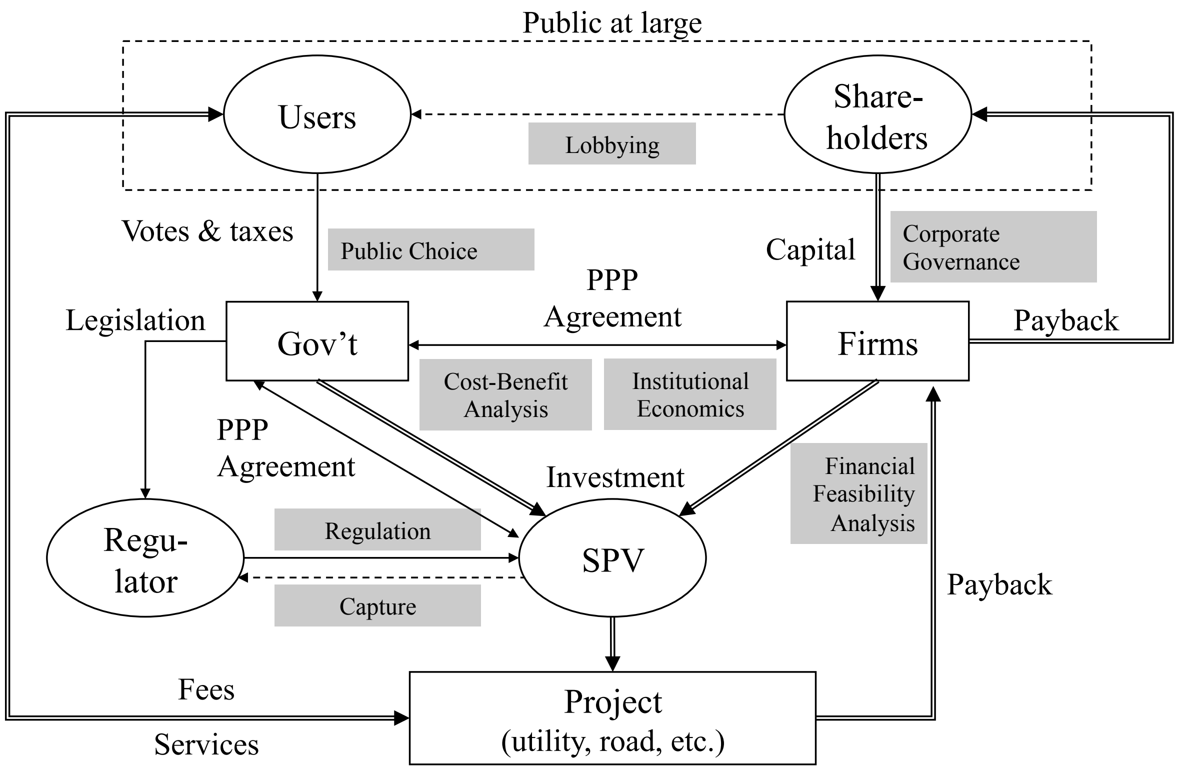
- Partnerships UK, http://www.partnershipsuk.org.uk/projectsDatabase/projects-database.asp
- World Bank's Private Participation in Infrastructure Project Database, http://ppi.worldbank.org

[4] Regulatory capture is a phenomenon in which a government regulatory agency which is supposed to be acting in the public interest becomes dominated by the vested interests of the existing incumbents in the industry that it oversees.

variability in demand that is outside the control of the private partner, such as variations in the business cycle, new market trends, direct competition, or technological obsolescence. It is important that, when planning a PPP, public managers stipulate the mechanisms of risk allocation and quality regulation in the contract.

Figure 1 presents an analytical model of the relationships between the partners and stakeholders in a PPP.

Figure 1
Analytical Model of Public-Private Relationships



Note: double lines represent capital and business transfers, solid single lines represent contractual and legal relationships, and dashed lines represent informal ties and influences.

In a PPP there concur capital and business transfers, contractual and legal relationships, and informal ties and influences between public and private agents, involving diverse research fields, for which there is a rich literature.[5] The present paper focuses on PPP agreements and PPP regulation design in local governments.

[5] On public choice refer to Buchanan and Tullock (1962); on regulation, lobbying, and capture: Stigler (1971), Hard, Shleifer and Vishny (1997), Viscusi, Vernon and Harrington (2000); on cost-benefit analysis and financial feasibility analysis: Zerbe and Dively (1994); on institutional economics and corporate governance: Williamson (1985). We abstract from illegal actions (corruption and unlawful expropriation).

2. Selection of Projects

Once the administration recognizes and agrees on the benefits of PPP (for a list of the benefits of using PPP in urban development, see McQuaid, 1999), planning and implementation can begin.

In the case of Warsaw, there were three primary criteria for project selection, consistent with the normative public sector's goals of effectiveness, efficiency, and equity (Forrer et al., 2010:475):

- Need: projects must serve and fulfill a real gap in the service to the local community.
- Challenge: projects must serve as benchmarks for future projects in the same sector.
- Attainability: projects must have a high probability of success.

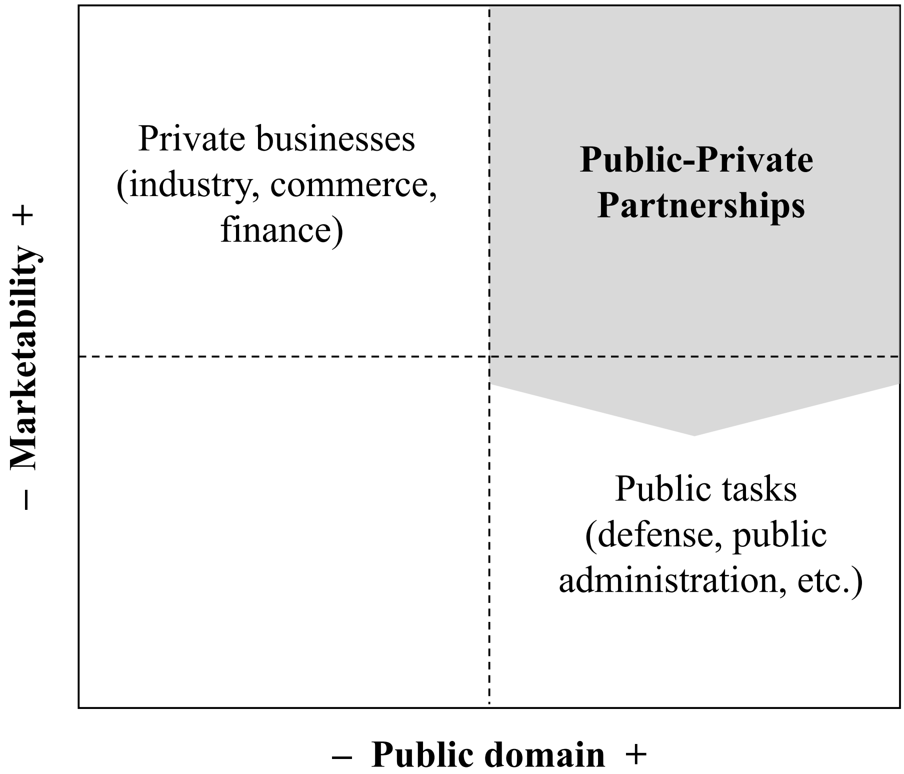
Over the past 20 years, economic and social realities have changed radically in Poland,[6] and the need to increase the quality of public services has risen dramatically. After years in which public infrastructure was deteriorating or growing only slowly, a new challenge emerged for local governments: today, people rightly expect public services to be tailored to their needs, delivered efficiently, and developed to the highest standard. Investment needs in Warsaw have also been influenced by planned international events that can be a source of tourism and that demand the development of primary and ancillary facilities.[7]

The ideal PPP project provides services in the public domain—that is, services the provision of which is a responsibility of the government—and is marketable (for example, water, city transport, and sports facilities). Marketable services that are not in the public domain should not be candidates for a PPP since they constitute an area for regular business activity, nor should services in the public domain that are not marketable or that should not be marketable, such as defense and public administration.

[6] Poland has being seen as an attractive place to invest. According to the European Cities Monitor 2006 report prepared by Cushman and Wakefield (European Cities Monitor 2006), Warsaw was ranked #18 among the most attractive European cities for business, and as many as 50 of the largest 500 European companies wanted to invest in Warsaw. Moreover, it was the only European economy to sustain positive economic growth during the 2007-2009 world crisis.

[7] Warsaw celebrated the 200th birth of Fryderyk Chopin in 2010 and hosted the XVI International Fryderyk Chopin Piano Competition. Also, it is one of the host cities of the soccer Euro Cup 2012.

Figure 2
Mapping PPP within a public domain x marketability matrix



In recent years, PPP models have evolved toward public domain services, which are less subject to marketability (for example, city roads and public schools). These models include the application of shadow tolls, availability payments, and infrastructure lease-backs—mechanisms in which financial payments to the private partner come from the government, not from the market.

3. Projects Undertaken by the City of Warsaw

Taking into account the criteria of need, challenge, and attainability, city officials selected five sectors—environmental protection, transport, health care, education and science, and sports and recreation[8]—and short-listed 20 projects for further discussion: two waste utilization plants, seven parking lots, a city car line to suburban Piaseczno, a new traffic fine registration and collection system, a hospital, a technology park, and seven sports and recreation facilities (see table 1).[9] Out of these, 16 were greenfield and four were redevelopment projects, and all demanded substantial capital investments.

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[8] The tender on PPP advisory services for the city of Warsaw was published in the Official Public Bulletin (see: http://ogloszeniabzp.um.warszawa.pl/zamowienie.php?zamowienie=18348).

[9] Rather than a closed list, these projects are indicative of the discussions held by the city of Warsaw and are presented to reflect the practical exercise the city of Warsaw went through in 2007-2009. Final analyses, to be carried out by the consulting companies, may lead to a different list of priorities, projects, and means of implementation.

Table 1
PPP flagship projects in the city of Warsaw

Type of project	Description	Greenfield / Redevelopment
Environmental protection	– ZUSOK: waste utilization plant – ZUSOK II: thermal waste utilization plant	Redevelopment Greenfield
Transport	– 6 underground parking lots (Defilad, Teatralny, Sienkiewicza, Emilii Plater, Spiska, Wawelska) – Multi-story parking lot (Targowek district) – City car line to suburban Piaseczno – Traffic fine registration and collection system	Greenfield Greenfield Greenfield Greenfield
Very large buildings	– Hospital – Technology park	Greenfield Greenfield
Sports & recreation facilities	– Hutnik Club field and ancillary facilities (Bielany district) – Miedzeszyn sports facilities (Wawer district) – Indoor swimming pool (Wlochy district) – Arena Varsovia hall (Targowek district) – Ursus Club sports and hotel facilities (Ursus district) – Wisla Recreational Center (Gorczewska) – Polonia Club facilities	Redevelopment/ Greenfield Greenfield Greenfield Greenfield Redevelopment Redevelopment

Source: City of Warsaw press release no. 18086 of February 11, 2009.

To provide an overall view of the projects, the basic rationales and examples of risk allocation between the public and private partners of several projects are presented next.[10]

Arena Varsovia was treated as a priority investment because Warsaw lacked the infrastructure it needed in order to organize large, prestigious sports, business, and cultural indoor events. In order to meet this need, city officials specified that the Arena Varsovia Center must hold approximately 12,000 people. The design and building risks lie entirely with the private partner, as does the later management of the facility.

The sports facility was also chosen because of public need in particular districts. The plan is for these sports facilities to be financed and operated by private investors and for the city to be able to purchase bulk hours at a discount for public schools.

The parking lots will be located under main squares and traffic-congested areas. According to feasibility studies, these investments can be completely financed and operated by private investors. However, in the case of underground parking lots, according to local law, the real estate beneath the squares cannot be unbundled and sold since the city is the owner of the squares. Therefore, the operator will work on a concession or long-term lease.

[10] Performance measures, although specified in detail in the PPP projects and of fundamental meaning for the quality of public services, have been omitted from this paper due to the extensive length of the lists - in some cases, more than a hundred pages.

Warsaw's largely residential Ursynow district, with 300,000 inhabitants, did not have a hospital. Under the PPP formula, the hospital will be financed and operated by the private investor. Some of the services will be contracted by the National Health Fund (NFZ), so users who are insured by NFZ will be provided service at the same quality level as those who use the hospital on a fully paid basis.

4. Ex Ante Constraints

Forrer et al. (2010:479-482) present a six-dimension model to assist public managers in improving PPPs' public accountability based on risk, costs and benefits, political and social impacts, expertise, collaboration, and performance measurement. In line with this accountability model, city managers established three ex-ante requirements for PPP projects to be taken into account in the planning and tailoring process:

- private management involvement (not only capital),
- public control of service quality through Key Performance Indicators (KPIs),
- modeling as a non-generating public debt PPP

4.1. Private Management Involvement

Since it is the wealthiest city in the region, Warsaw can undertake almost all needed public investment on its own through debt markets, without the involvement of private equity financing. With annual revenues of PLN 7.7 billion (EUR 2.1 billion) in 2006,[11] Warsaw could bear debt of PLN 4.6 billion (EUR 1.2 billion).[12] Warsaw's public debt in 2006 was PLN 2.6 billion,[13] so there is still room for an additional PLN 2 billion (EUR 540 million) in debt.

However, the city authorities realized the fundamental role of private management involvement as a cost minimization factor and a source of service quality. Moreover, private funds release public funds to be used for other priorities, while enhancing the city's credit ratings.

4.2. Public Control of Performance and Quality of Service

The city of Warsaw committed to exercising control of quality of the services delivered by the private partners through KPIs, measures specifically tailored for each sector and for both primary and secondary services. KPIs establish a benchmark for providers and communicate to users that the service, although privately provided, remains a public responsibility and in the public domain. KPIs are central to the positive social perception of a PPP, so they should be published, if possible, to ensure the accountability of third parties. KPIs must be established in the contract, as must the measurement methodology, acceptance standards, frequency of controls, and consequences if standards are not met.

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[11] Resolution No. LXIV/1947/2005 of the Council of the city of Warsaw on the budget of the City for the year 2006.

[12] At the time of writing the paper, the maximum debt allowed for local governments in Poland by the Public Finance Law was 60 percent of planned annual revenues.

[13] Quarterly report Rb-K on the debt of local governments for 2006.

4.3. Modeling as a Non-Generating Public Debt PPP

Eurostat's[14] ESA95 standards (cf. STAT/04/18 of February 11, 2004) specify the accounting treatment in the national accounts of contracts undertaken by government units in the framework of partnerships with non-government units, and their impact on government deficit and debt. According to these standards, the assets involved in a public-private partnership should be classified as non-government assets and recorded off-balance for the government unit, if they meet two conditions:

- the private partner bears the construction risk
- the private partner bears either the availability or demand risk or both (European Commission, 2004).

Therefore, out of the eight possible combinations of construction, availability, and demand risks, only three can be recorded off balance sheet and accounted as a non-generating public debt PPP (see table 2).

Table 2
Non-generating Public Debt PPP (according to Eurostat and Polish Law)

Risk	0 = publicly held, not transferred 1 = transferred to the private partner							
	Off-balance sheet PPP			In-balance sheet PPP or no PPP				
Construction	1	1	1	1	0	0	0	0
Availability	1	0	1	0	1	0	1	0
Demand	1	1	0	0	0	1	1	0

A risk is considered to be transferred when the private investor assumes the major share of the consequences attached to a risk category.

5. Stages in PPP Contracting and Regulation

The starting point for any successful PPP is the public authorities' reaching consensus on its goals. If complete agreement on the benefits of a PPP is lacking, the public mandate to prepare and execute the contracts will not be strong, and the private partner can take advantage of this during negotiations. In Warsaw, the mandate was explicit and a deputy mayor was responsible for the whole process, which was executed through the Investors' Service Office, a newly created unit.

After selecting the projects and performing the preliminary feasibility study, the Investors' Service Office decided to put out a tender for advisory services from consortia of financial, legal, and engineering firms, the winners of which would be responsible for advising the city

[14] Eurostat is the statistical office of the European Union.

on the process for undertaking certain projects[15] Although involving external consultants was not legally compulsory, there were two reasons for doing so: the lack of expertise in PPP modeling in the city of Warsaw added value to the contribution of international consulting companies that could bring expertise from other countries where PPP solutions work, and the engagement of independent consultants would strengthen the objectivity of the process to safeguard city authorities against complaints, criticism and challenges by subsequent administrations. The latter concern is especially important in countries in which the rule of law is weak and probity is not obvious and where third parties may protest that the process of consultation and cooperation between the public and private sectors has crossed over to collusion.[16] The purpose of offering the tender for consulting services from consortia, rather than individually with financial, legal, and engineering consulting firms, was to facilitate the focus of city managers' communications to one point and to encourage concise proposals from consultants.

The choice of advisory consortia was made in a two-stage public tender. In the first stage, four consortia, led by renowned companies, were selected based on their experience, credentials, and the curricula of key experts.[17] In the second stage, city managers will negotiate terms and conditions directly with the four short-listed consortia.

When a project is awarded to an advisory consortium, the city managers and the advisory consortium will prepare the business model for the project, the KPIs, and the tender documentation for private investors. Next, the advisory consortium will support the city during contract negotiations with private investors, and the contracts will be signed.

During the preparation of business models and negotiations with the private partner, risk allocation between the parties will have to meet the established criteria so that payment obligations on the city can be considered off-balance sheet. Governments have a variety of instruments that can help them mitigate the risks transferred to the private partner, such as the transfer of land for a certain period, bulk purchases of services, and limitation of direct competition in a certain area. For example, in the case of the *Arena Varsovia*, the city will participate in the investment by providing the land and by guaranteeing a minimum demand. A similar mechanism of risk mitigation will be used in sports and recreation facilities, from which the city will buy bulk hours for schools. In the case of parking lots, in order to limit the demand risk transferred to the private investor, the city authorities will commit to rigorous execution of the restrictions on parking zones in the city streets.

The last open-ended task remaining for the government will be the monitoring and performance evaluation of the private partner. If the terms of the contract are not fulfilled, the city should have the option of imposing fees or even terminating the contract (although sometimes terminating the contract is difficult to achieve; see Ball and King, 2006).

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[15] See the Official Public Bulletin:
http://ogloszeniabzp.um.warszawa.pl/zamowienie.php?zamowienie=18348 for details on the tender on PPP advisory services for the city of Warsaw. One of the authors (Moszoro) was involved in the design of this two-stage tender mechanism.

[16] Leitch and Motion (2003) describe a recent example of public-private collusion.

[17] Selected consortia were to be led by Deloitte Advisory, Depfa Bank, Ernst &Young, and PriceWaterhouse Coopers (cf. City of Warsaw press release no. 18086 of February 11, 2009).

6. Policy Recommendations

Seven specific policy recommendations can be drawn from the implementation process of PPP by the city of Warsaw.

First, until tenders are released and the regular performance evaluation can be passed on to individual departments, it is important to have a central headquarters for the coordination of the PPP planning process between the city departments and private investors. In Warsaw, this role was fulfilled by the Investors' Service Office.

Second, the administration should clearly define its selection criteria and constraints for the projects.

Third, in young democracies and emerging economies, independent advisory companies play an important role in bringing in expertise in PPPs and help to strengthen the legitimacy of the process for subsequent administrations.

Fourth, financial models are secondary to risk allocation and performance measurement. Our experience is that many local governments focus too much on the financing side and underestimate the importance of *ex ante* risk allocation and the *ex post* performance measurement procedures connected to payments.

Fifth, even when a partnership is expected to last for a long period, partnership termination conditions must be predetermined in such a way as to discourage the partners from engaging in opportunistic behavior at the expense of the other party.

Sixth, theoretical advice cannot replace practice. Since each urban area is unique in its own way, there is no ideal pattern to follow. Warsaw chose several projects that can be transformed into success stories, but they are also projects from which officials can learn by doing.

Seventh, and finally, mechanisms should be in place to retain the benefit of the knowledge acquired during the implementation of the projects. Accordingly, the city of Warsaw required the advisory companies to provide training sessions for the city employees responsible for the PPP process and execution.

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