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INFRASTRUCTURE CONSULTING

Financing New Zealand's Infrastructure
A look at the global trend of Public-Private Partnerships

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This article offers some of the background to development of Public-Private Partnerships (PPPs) and their increasing use globally in the supply of basic infrastructure.

The question has long been before us. Which services should the State take responsibility for and how are these services best provided? This is not a new issue for New Zealand, nor are we alone in facing the question of how the State is to continue delivering the right level of services to the public.

Finding the Right Balance

When it comes to financing infrastructure-related public services, we are faced with three options. The first is to continue funding capital projects from the public purse, the second is to pass infrastructure ownership and management over to the private sector entirely or, thirdly, find some middle ground between these two alternatives.

If the State continues to fund projects out of its own pocket, the implications are either:

(a) Increased taxes and rates;

(b) Public sector borrowing to a point where New Zealand's credit quality might be impaired, or;

(c) Infrastructure simply not being developed fast enough to maintain the quality of life the public reasonably seeks.

Equally, moving the burden over to the private sector raises a variety of issues as did privatisation of State assets in the 1980s and 90s.

Getting the delivery of public services right has also occupied governments of other countries and it is fair to say that the United Kingdom is the most advanced in its thinking. During the 1970s, the U.K invented privatisation as a means of reducing public sector borrowing and taking pressure off the State in the delivery of core infrastructure such as electricity, gas, treated water and sewerage and roads.

New Zealand followed suit of course, but not to the same extent, as businesses such as Meridian, Genesis, Mighty River Power, Christchurch International Airport and others remain as either State Owned Enterprises, Crown Owned Companies or in the hands of Local Governments. This is partly because of changing governments and political will, but the process has also been slowed by public criticism of some of the philosophies associated with privatisation and the performance of some privatised companies. There have also been specific concerns over the handling of certain sales and deregulation of the electricity supply industry.

Project Financing - The PPP Nursery

Deregulation went hand in hand with privatisation, and, as markets deregulated around the globe, the private sector has been increasingly called upon to develop new infrastructure. The need for private capital for those developments has grown at the same rate and this has given rise to what is known as the Project Finance industry.

Project Financing involves project lenders looking primarily to the project's cash flows for repayment, rather than to the project's shareholders or the host government. This form of financing has become popular in developed and developing nations alike. In developed countries, privately financed infrastructure has been a natural next step from privatisation, where the newly privatised companies needed to continue expanding domestically and overseas. Conversely, in developing countries private finance for infrastructure has been driven principally by governments seeking the supply of new public services by the private sector, but on their own terms.

Those terms have brought about the popular use of ownership concepts such as the Build-Operate-Transfer (BOT) model, which dates back to at least the construction of the Suez Canal. A BOT project sees the private sector, usually through several companies working as a consortium - taking responsibility for building, funding and operating a project under a concession granted by a governmental body. In this case, the asset may be transferred to the government at the end of the concession period, usually being around twenty five years. Choosing a consortium to develop the project is usually made by the government following a competitive tendering process, with selection being based on the price of the service being offered by tenderers and the degree to which risks are to be absorbed by the private sector.

Under the BOT model, ownership of the asset never rests with the private sector, but there are a variety of derivatives of the model. Two of the more usual examples include the Build-Own-Operate-Transfer (BOOT) and Build-Own-Operate (BOO) modalities.

The Project Finance market is an important interim step between privatisation and PPP, because it employs a type of financing that has proven successful when performed properly and with the right resources. However, Project Financing has also fallen short in a number of areas, not least being that they are decidedly idiosyncratic in their nature and require large teams of skilled professionals to pull them together. Even then there are no guarantees that the project in question will reach fruition and many governments and developers have the scars to prove it.

That Project Financed projects are highly tailor made can be illustrated by reference to their documentation. Adrian Montague, the former head of the UK's Private Finance Initiative Treasury Taskforce (PFI), worked for the British law firm Linklaters for a period in Hong Kong. There he was responsible for the legal aspects of several landmark project financings and, on his departure, he rather famously quipped that Power Purchase Agreements become tiresome after drafting more than thirty of them.

A further, major, shortcoming is that governments have fallen into the trap of thinking that Project Financing means they can happily wash their hands of project risks while still procuring a new public service. This has led to concession based projects often transferring a disproportionate share of the risks onto the private sponsor, a situation fuelled by perhaps unhealthy competition by developers for projects. Irrespective of the cause, a frequent consequence has been delays in the development of project agreements, difficulties in raising finance for the project and a few high profile disasters along the way.

These are the issues that the PPP model attempts to take on squarely, by creating a public sector hub of expertise, standard documents and processes, and a transparent procurement process.

New Thinking

Perhaps it is no surprise that thinking in the U.K has changed considerably since the heady days of Margaret Thatcher's privatisation programme. However, so great is the change that instead of passing the role of providing public services onto the private sector through privatisation, the government under its Private Finance Initiative (PFI) again becomes the service provider while contracting out those elements that the private sector does better. PFI, then, is the British name for the model that is now more widely referred to as PPP.

Thus, government takes on the role as planner, procurer and regulator of services and takes responsibility for their delivery to the public. The private sector, on the other hand, assumes the role of designing, building, financing and operating the new service (or parts of it) within performance standards laid down by the State. In the UK, a PFI contract typically runs for 30 years with the private company receiving either:

(a) Regular payments from the State, and/ or;

(b) Revenues from the users of the infrastructure based on formulae agreed by and regulated by the State.

In both cases, payment depends on the level of service provided by the private company.

The introduction of fixed payments from government achieves two things. The first is that a range of projects categorised as "social infrastructure", like hospitals, schools and prisons, can be developed under a PPP because they remain State run. Secondly, when a government is paying the private company for the delivery of a service, the project is simplified. The result is that less structuring of the project is required and, therefore, smaller projects become eligible for private finance. That finance might take the form of Project Finance or it could be financed from the balance sheet(s) of the private sector sponsor(s).

Not Without Fault

Like privatisation, the PFI has not been without fault or controversy, especially regarding commentary that PFI schemes are an expensive form of hire purchase and needed only because of firm limits imposed on the UK's public borrowing levels. This concern is heightened when it is clear that the private sector cannot usually borrow as cheaply as a government.

Counter-arguments put forward by proponents of PFI say that public sector borrowing costs are spread across the whole population, which is not consistent with the principle of user pays. A further argument is that major capital projects have a history of massive cost overruns when managed by the public sector. For example, in Britain, the Jubilee line extension of the London Underground cost an extra £1.5 billion and here in New Zealand we have our own example in the Clyde Dam, which cost an additional $1 billion. Under a private financing, the private company bears the risk of most cost overruns, which is proven to be a major incentive not to let them occur in the first place.

Whatever the arguments for and against, the results of bold new thinking never come easily and having worked through the issues attendant with those initial problems, the PFI is now at a point where over 400 projects with a total capital value of some £20 billion have been signed. In the next three years, it is expected that around £4 billion per annum will be committed to new public services such as roads, schools and hospitals. Critics in Britain also accept that the more recent PFI projects are offering better value for money and banks are reducing the costs of borrowing as they become more familiar with the new market.

Use of the Model Outside Britain

Various governments have taken a good look at the PFI model to see how they might apply it in their own countries. These include Australia, Canada, Italy, Japan, the Netherlands, Portugal and Spain.

Given its proximity, the Australian PPP programme is worthy of particular attention. Victoria, New South Wales and Queensland have each adopted their own approaches, but efforts are being made toward achieving uniformity amongst them. Nonetheless, Victoria, being fresh from implementing its highly successful and formulaic privatisation strategy, is the most advanced of the three states, with the creation of Partnership Victoria.

Some eleven Victorian projects spanning hospitals, transport, prisons and information technology are in the pipeline as PPPs. The hospitals and prisons are interesting examples, since they will involve the private sector building the new facilities and providing the facility management. However, the State will retain control over the delivery of medical services for the hospitals and correctional services for the prisons.

These cases also involve the supply of new, standalone, infrastructure. This is significant because public opinion is likely to vary depending on whether a project involves:

(a) The creation of new, discrete infrastructure;

(b) The creation of new assets that are integrated with existing infrastructure currently owned and managed by the State, or;

(c) Simply passing the management of an existing asset into private hands as a PPP.

Consequently, it makes sense to initially target projects that fall into the first grouping so that the process can proceed more smoothly.

A further issue that affects the rate at which Australian PPP projects can be implemented is market readiness. The infrastructure finance market is well developed in Australia, both in terms of the depth and complexity of the capital markets and the skill-set required for concluding deals cost effectively.

The New Zealand market does not have the experience of its Australian counterpart, so there will be a need to ascend the learning curve quickly if a PPP programme in New Zealand is to achieve early success. This is perhaps less of an issue for the private sector, as skills and capital will find their way across the Tasman if there is good cause. It is an issue for the public sector, though, because skills must be either bought, gained by experience here or via public servant secondments overseas. For this reason, there are strong grounds for the creation of a critical mass of expertise in the public sector that is a centralised resource for ministries, departments and local governments. That approach will significantly reduce duplication.

New Zealand

New Zealand has been slower in its adoption of a PPP model than some, but the term "Public Private Partnership" has been in the national vocabulary since at least the 2001 Birch Report for the Auckland City Council and perhaps even earlier when the Treasury reviewed the PFI as an option for the financing of the new Wellington hospital. In addition, provision for this model of procurement is being made more formally now through a new Local Government Bill that is expected to come into force in July 2002.

That is not to say, of course, that resistance to PPP in New Zealand has been laid to rest by any stretch of the imagination. Opponents of privatisation might quite reasonably say that simply copying what has been done elsewhere has not done us much good. While there may be some basis to those concerns, the alternative is that we either stick with the status quo or we develop something new for ourselves. However, our problems are not so different from other countries to warrant an entirely new model, so it would be imprudent not to, at least, examine carefully what other countries have done.

All in all, using our own versions of the Public-Private Partnership model for developing infrastructure has the potential to draw out the best of the two sectors. At the same time the public can be comforted by knowing that the State is not reneging on its obligations to serve society.

Future articles will explore how to manage the more significant issues facing PPPs in New Zealand. Interest in receiving these articles can be expressed by subscribing for newsletters on the Ridgway website.

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