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ASPECTS OF RISK TRANSFER IN PUBLIC PRIVATE PARTNERSHIPS

NEPAD/SADC REGIONAL INFRASTRUCTURE PROJECTS CONFEFENCE

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Infrastructure:

- is the basic structural foundation of a society or enterprise
- is the base from which activity can be generated and grow
- has considerable resource requirements, hence it has tended to be the province of Government
- has tended to be funded and project managed by the public sector

Infrastructure cont’d

- From an economic opportunity point of view, the private sector cannot ignore opportunities to participate in infrastructure development opportunities presented by the public sector.
- The private sector may on occasion wish to take the lead in the delivery of various facets of infrastructure but is constrained by regulatory considerations and the enormity of the capital outlay required
- Projects usually have a mix of social and economic effects. If the preponderance of effects is:
  - social, the call on the relevant Government is greater ;
  - economic, it is easier to facilitate the participation and active involvement of the private sector

Infrastructure cont’d

- The foregoing demonstrates that there is vast scope for co-operation between the public and private sectors
- There is a symbiotic relationship between the 2 sectors
- The relationship is being recognised more and more in public private partnerships

Infrastructure cont'd

- PPPs have been in use in the US since the mid 20th Century and in Europe, Asia and other developing countries since the 1970s
- Previously, the inclination was for the private sector to participate in infrastructure projects under the safety of a government guarantee
- Lenders eventually adopted a pragmatic approach and began focusing on the cashflows generated by the project .
- The central instrument in a PPP is the concession agreement

Risk

- Cashflow based financing requires the exhaustive identification, analysis and mitigation of all risks
- Normally risk is sought to be transferred from the public sector to the private sector
- Risk transfer has an impact on affordability and value for money (VFM)
- Normally the public sector kicks off the process by constructing an initial business case as part of affordability assessment.

Risk cont'd

- A component of the business case is the "reference project".
- The public sector comparator (PSC) is then constructed and is the benchmark against which VFM is assessed .
- With the construction of the PSC, Government becomes more aware of risks it needs to transfer.
- In the risk transfer scenario, Government remains aware of the link between risk assumed by the private sector and the private sector's return expectations

Risk cont’d

- The PSC is used to assess bids received from the private sector to determine which bid has the best VFM.
- Government’s VFM enquiry is based on an appraisal comparing the economic costs and benefits of alternative investment proposals
- The net present cost of in a PPP should be lower than the relevant PSC.

Public Sector Perspectives

- Risks include all factors which cannot be definitively predicted and incorporated into the project costing
- Typical risks include unforeseen engineering problems, cost and time overruns, currency exchange variations, unreliable market and demand projections, environmental and social costs.
- It is extremely difficult to assign probabilities to the occurrence of many of the risks and even more difficult to value them.

Public Sector Perspectives cont'd

- Risk sharing in all PPPs is prominent as not all risks can be transferred.
- Government's approach should be to specify the output it wishes to achieve. This gives the private sector freedom to design an efficient and cost-effective product.
- Government can insist that payments are related to the delivery of the contracted service at the required quality.

Private Sector Perspectives

- The primary concern of the private sector partner is to achieve an adequate return on investment
- Risk allocation should be symmetrical
- Infrastructure projects usually have a mix of indirect costs.
- Because indirect costs are difficult to quantify, the private party will seek to exclude them from the cost structure of he project

Private Sector Perspectives cont'd

- The risks of traditional vis major / force majeure (act of God) events can be shared
- The influence which lenders can bring to bare on the project should not be overlooked.
- Risks associated with the design, construction, financing and operation of a PPP asset are normally borne by the private party.
- The private party is normally required to work on a "payment by result" principle right from procurement and through the life cycle of the services

Conclusion

- It makes sense for the public and private sectors to work together on infrastructure projects.
- In PPPs, a degree of risk transfer is expected. The challenge is to arrive at the optimal level of risk transfer.
- The public sector should be entitled to expect significant cost savings and value from PPPs.
- The Private sector has a legitimate expectation of a fair return.