

## *newsletter*

# Public Private Partnerships (PPP)

**Nowadays, a substantial volume of government investment is carried out in the form of public private partnership projects. This gives insurers the opportunity to open up new business areas and participate in this trend, both in their home markets and in developing and emerging countries.**

- Introduction** Many countries need to invest heavily in infrastructure and transportation routes, schools and other facilities traditionally built and run by government and local authorities. However, the stretched financial situation in the public sector has meant that many such projects have had to be postponed in recent years or, in the case of developing and emerging countries, have not even got off the ground. Public private partnerships could be the ideal solution for avoiding investment backlogs and going ahead with important projects.
- Definition** A PPP is a long-term cooperation agreement between a public principal and a private partner, eg for the duration of or even beyond the completion of a specific project. It is distinct from privatisation in that the public body delegates only some of its duties to private business, while retaining overall responsibility. In its legal essence, a PPP is typically a very-long-term rental or leasing contract. PPP projects run through a number of phases: demand assessment, project suitability test, market reconnaissance, choice of contract placement procedure, compilation of documents for invitation to tender, ITT procedure, award and performance of contract, and project controlling. Contracts generally run for between 10 and 30 years.
- Origins, stakeholders, objectives** PPPs are not a recent invention. As early as 1589, the Perrier brothers were contracted to construct a water-supply system in Paris. Further major privately funded projects included the Suez Canal and the Panama Canal. In the UK, about 20 % of government investment is currently channelled via PPP projects known as Private Finance Initiatives (PFI). PPP projects bring together the public sector as the principal, the construction & plant engineering industries (execution), investors (banks, insurance companies and investment companies) and service providers (operators). The aim of PPP projects is to enhance cost efficiency in delivering government services. This efficiency gain is achieved by optimised division of labour, with each participant contributing its own strengths. Partnership with private investors is intended to relieve the burden on strained public budgets. Especially in the case of complex projects, it is assumed that taking advantage of the business acumen of private investors will help improve efficiency and shorten project times.
- Fields of activity** PPPs cover a wide range of activities. In industrialised countries, these are mainly:
- construction projects: building, renovating and running schools, hospitals, correction facilities and other usually public buildings such as sports facilities, town halls and public authorities' office buildings

- transportation infrastructure: building and maintenance of roads, bridges, tunnels, inland waterways, airports, toll systems
- utilities in the fields of power and water supply, sewage and waste disposal, or public health services.

In Asia, Africa or Latin America, by contrast, the population profits mainly from projects dedicated to improving health care or disaster management.

**Current projects** There is a great demand for new investment projects and modernisations. That is why almost every day brings reports of new PPP projects. The best-known project in Germany is probably "Tollcollect", the joint venture set up to install and run a toll system for HGVs on German motorways. But PPP projects are also frequently to be found at local government level.

**Models for organisation** The PPP notional umbrella spans the most diverse contractual constructs, distinguishable essentially by the way in which the investments are refinanced, eg via user charges (entrance fees, sewage rates). In some cases, however, refinancing is not possible.

The following types of PPP contract are common nowadays:

- public private joint ventures: cooperation model with joint public private ownership
- B&O: a private business builds and operates an infrastructure project and bears the entrepreneurial risk, the project is financed via user fees
- leasing: the investor builds and operates the project; on expiry of the contract term the principal has the option of buying the asset at book value
- O&M: a franchise model; the public entity remains the owner and nominal operator, the private contractor works for and on behalf of the public owner, performing mainly operations management, maintenance and servicing
- BOM: a hybrid form between B&O and O&M; the private operator has extensive powers of discretion, eg is free to conclude contracts with third parties.
- BOT: Build, Operate, Transfer covers turnkey construction, funding of the preliminary costs, project management, up to transfer of operations in the start-up phase
- performance contracting: the project is paid for entirely via the energy savings achieved through improved efficiency

**Advantage, prospects** As a PPP contract typically specifies a defined scope of services for a defined (long) period in return for a fixed remuneration, it gives the public principal greater certainty in terms of long-term planning and budgeting. Thanks to the long contract term and the superior creditworthiness of the public sector, the private investors can likewise rely on long-term certainty for their future planning.

Tapping new financial resources relieves the burden on the public budgets. The risk of a delay in construction or of business interruption due to construction constraints (eg inability to collect tolls) is converted into an entrepreneurial risk with no deficits for the public partner. The economic loss can be precisely quantified and, if necessary, recovered from the private partners by way of recourse.

**Disadvantages, risks** As a funding instrument, PPP is much less flexible than a loan, because it usually involves long-term payments for use of specific real-estate assets. The long contract term ties the principal into long-term financial obligations. As long-term forecasts always entail major uncertainties, there is a risk of the underlying conditions (eg subsidies, tax legislation) changing during the term of the contract. The private investor can rely neither on protection nor guarantees against competition. Because private investors' credit rating is usually lower than a government's, the cost of funding PPP projects is often higher than that of public-only projects. Despite very careful selection procedures, the private investor could run into financial distress or even become insolvent, which could jeopardise the future of the project.

**Information for the underwriter** The endeavour to tap the financial resources and to harness the innovation potential of private business is a special incentive for the public sector to involve private investors in providing public services. As a result, more and more investment needs are being channelled via PPP models. This means that risks that have hitherto been borne by the public sector are now being transferred to private business. For the insurance industry, this is an opportunity to open up new business areas. Indeed, in many cases the involvement of the insurers is a prerequisite for the long-term success of such models.

The insurers can participate in a number of ways:

- via traditional products: engineering insurance for construction projects (EAR, CAR, DSU, ALOP); property insurance for the assets constructed; business interruption insurance (BI) for the operating phase
- via non-traditional products: credit enhancement; contingent capital; microinsurance; weather derivatives
- as capital providers: project financing

The specific risks involved in PPP projects mainly include:

- long clarification phases before the project actually gets going
- obscure planning, contracting and management of the project
- long contract terms
- changes in the political background (guaranteed prices, tax legislation)
- exchange rate fluctuations in the case of international projects
- rival projects (eg parallel tunnels)
- insolvency of the counterparty

In the light of the size and technical complexity of many PPP projects, the underwriting decision should be based on a comprehensive risk assessment, including risk engineering aspects.

## Contact

AssTech GmbH  
Postfach 1211  
85766 Unterföhring bei München  
Telephone + 49 89 3844-1585  
Telefax + 49 89 3844-1586  
info@asstech.com  
www.asstech.com