

# Public-Private Partnerships (PPP) – A Decision Maker's Guide



**Michael Burnett**

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## **Note on the Author**

Michael Burnett is a UK Chartered Accountant, a member of the Chartered Institute of Personnel and Development and a member of the Chartered Institute of Purchasing and Supply with more than 20 years experience in public procurement and PPP in 15 European countries.

He created EIPA's European PPP Forum, is currently directing their international training programmes in PPP and is a member of the editorial board of the European PPP Law Review.

He is the author of *Basic Bookkeeping – A self study guide* (Institute of Chartered Accountants in England and Wales, 1984), *Management Accounting – A guide for civil servants in Estonia* (EU PHARE project publication, 1996) and (with Eugen Palade) *Public Procurement in FYR Macedonia – A self study manual* (EU CARDS project publication 2006).





# Foreword

For someone coming to an academic environment after a long career as a practitioner in public procurement and PPP, writing this book has been like a journey into uncharted territory, an experience unlike the three previous study guides which I have authored or co-authored.

Part of this journey has been the sharing of ideas with colleagues inside and outside EIPA, which has undoubtedly made this a better book. In particular, I would like to recognise the contribution of my colleagues Liisa Koskinen, Phedon Nicolaides and Robin Smail for their comments respectively on matters relating to public procurement, competition and structural funds.

The list of colleagues who I would like to recognise in the wider PPP community includes in particular Mike Allen, Martin Darcy, Oliver Hattig, Velia Leone, Martin Oder and Christina Tvarnø and also several colleagues in the European institutions who know who they are but whose anonymity I have preserved. They have all been particularly generous with their comments even though, in some cases, they know that they may not agree with all of the conclusions.

Finally, and very importantly, I would like to acknowledge the support of Rita Beuter at EIPA for creating the conditions within which it has been possible for me to write this book.

I thank all of them for their help but, of course, final responsibility for the opinions expressed remains my own.

Michael Burnett  
Maastricht, the Netherlands  
July 2007



# Introduction

The objective of Public-Private Partnerships (PPP) is a partnership between the public and private sectors to deliver services to the public. They are now firmly established in this role in the European political landscape. There has thus been a rapid growth in use of PPP in recent years and there is every likelihood that they will continue to be increasingly used in the future.

It would be a bold claim to suggest that, for a European decision maker, an understanding of PPP is essential. But it is hard to overstate the potential importance of PPP to the future delivery of public services in the EU. In particular, PPP are vitally important to the implementation of EU policies and will be for the foreseeable future because of the “funding gap”, the gap between the financing needed to implement these policies and the public funds available both from national and EU budgets. The clearest examples of this are the costs associated with the need to complete the EU Internal Market by completing the Trans-European Networks (TENs), and enabling Member States, and particularly the new Member States, to comply with EU environmental legislation.

So this is a book with an unashamedly European mission i.e. to ensure that PPP can make the contribution which they are properly capable of making to the implementation of European policies both at European and national level. This is not, of course, to deny that many of the lessons are relevant to the use of PPP for delivery of services such as health, education, leisure and social services which primarily fall within the competence of Member States.

The book has two main audiences, i.e. European decision makers and politicians and senior public officials in EU Member States, though of course it may also be of value to others, such as private sector operators and financiers, who interact with decision makers.

Firstly, it is written for European decision makers responsible for creating an appropriate legal framework at EU level for PPP and wanting to

understand the impact of European policy decisions on how PPP are used to implement them.

Secondly, it is written for politicians and senior public officials currently facing choices about when and how to use PPP and also how to remove administrative and legal barriers to using them at national level.

It is a book which the author considers to be timely because of the long term nature of commitments entered into when a public authority<sup>1</sup> engages a partner for a PPP – often by means of a contract for 25-30 years or more. Many of the decisions being made now will influence the delivery of public services in Europe for the foreseeable future (and well beyond the shelf life of today’s political leaders) and the International Monetary Fund (IMF) has highlighted the importance of managing at national level the fiscal risks associated with such long-term commitments.<sup>2</sup>

In the author’s experience, one of the key issues facing politicians and public officials in understanding PPP and applying them effectively is the difficulty in obtaining balanced guidance. Much of what is available both in books and on the conference and seminar circuit is written by those with either a commercial interest in promoting PPP because they wish to be engaged in it as suppliers or as professional advisers or those who are ideologically opposed to its use.

So this is also a book driven by a public sector mission i.e. to try to fill this gap in the literature. It is written from a neutral standpoint on PPP in three respects:

- It is not written from the perspective of the interests in PPP of service providers or of any particular public administration
- The view that PPP are sometimes but not always the right means for achieving value for money in public service delivery<sup>3</sup>
- The view that the test of when PPP should be used should be pragmatic not ideological (i.e. that PPP should not be the default option for a public investment project but properly assessed on a case by case basis).

The book is not a study of the economic benefits of PPP, though an understanding of economics is necessary to understand when and why they might be useful.<sup>4</sup> Nor is it a detailed operational handbook on PPP, though it identifies the choices to be made in the implementation of PPP and addresses many of the key issues involved in making those choices.<sup>5</sup>

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<sup>1</sup> The term widely used in the EU context, and taken from the EU terminology, is “Contracting Authority”.

<sup>2</sup> See, for example, Gerd Schwartz, “Managing Fiscal Risk from PPP”, presentation at 3<sup>rd</sup> Pan-European PPP Forum, Prague, June 2006 and Richard Hemming *et al*, *Public-Private Partnerships, Government Guarantees and Fiscal Risk*, IMF, 2006.

But in one respect it is more ambitious than a text limited to how to implement PPP in a particular project i.e. it addresses the need for overall management of a PPP programme on a coordinated basis at national level and a framework for assessing projects within such a programme. Put simply, a public authority cannot decide how best to implement PPP in a particular project until it has first determined and prioritised its investment programme, determined whether or not it has a financially and/or economically viable project and assessed whether a PPP is the appropriate solution for the particular project.

The book also reflects the author’s experience that the successful implementation of PPP requires a multi-disciplinary approach, blending political, economic, commercial, financial, legal and operational aspects and – often forgotten at key moments – those of people management. All of these elements thus belong within the scope of a decision maker’s guide.

Finally, in two specific respects, the book is a deliberate attempt to demystify PPP i.e. that:

PPP in essence are a form of long term, high value and often complex public procurement.<sup>6</sup> Thus the application of effective investment programme and project management and good public procurement practice will in the author’s experience go a long way towards success in the implementa-

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<sup>3</sup> For the record, the main alternatives to a PPP are direct public sector provision, conventional procurement separating the design and construction and service provision contracts and privatisation. This does not of course describe every refinement. There are also types of PPP in which the partner to a public authority is a not for profit organisation. In other cases the public authority is both customer and a joint venture partner in the service delivery. These latter have become known as “Institutional PPP” (IPPP). This book, however, is written in the context of what, in the author’s experience, is the highest priority for public sector decision makers i.e. the effective implementation of PPP between the public sector as customer and a private partner as service provider, though clearly the vast majority of the text is relevant also to IPPP. Privatisation as a concept is not the subject of detailed study in this book. For a fuller study of privatisation see Ernst Ulrich von Weisacker *et al*, *Limits to Privatization*, report to the Club of Rome, Earthscan, 2005. Privatisation of entities which provide services to the public is sometimes regarded as being conceptually different from other means of public service delivery and not as an extension of the continuum of private sector engagement which leads (in the sense of increasing complexity) from pure service operation contracts to operation and maintenance contracts, asset leasing and PPP. The author is of the view that to regard privatisation as being conceptually different from PPP is hard to justify given that, though there may a greater level of transfer of control over the delivery of the service to the private sector, it is not irreversible (as was shown by the return of Network Rail to public ownership in UK in 2001) if the conditions of sale are not met or the privatised entity is in financial distress *and the state cannot afford a service interruption*. In the case of privatised monopolies the standard of service is generally regulated by the public sector.

tion of PPP. Put another way, when looked at in retrospect many of the mistakes made in the implementation of PPP are ones which were or ought reasonably to have been obvious at the time and could have been avoided by effective programme and project management and good public procurement practice.

Because PPP are a form of public procurement their application should be undertaken within the context of the EU Public Procurement Directives<sup>78</sup> (the Public Procurement Directives), applied, of course, in the different national legal and administrative contexts for public procurement. As will be made clear later, the author considers that no useful purpose, either in terms of improving legal certainty<sup>9</sup> for PPP or in obtaining value for money from them,<sup>10</sup> is served by creating additional legal forms for PPP transactions separate from those defined in the Public Procurement Directives and, indeed, that further consolidation of the award processes would be desirable.

The author's intention is thus that decision makers will understand the essential elements of PPP transactions and the key practical issues faced in implementing both individual PPP transactions and a PPP programme, and thus be better placed both to create an appropriate legal framework for PPP and to manage the implementation of PPP effectively.

Writing this book from the public sector perspective does not, in the author's view, require any justification. It is a reflection of his experience that priority needs to be given to improving the capability of the public sector to commission and manage PPP. But in this focus on the public sector, there is no intention to fail to recognise the needs of private sector partners

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<sup>4</sup> For a wide ranging economic perspective on PPP, see, for example, Darrin Grimsey and Mervyn K. Lewis, *The Economics of Public Private Partnerships*, Edward Elgar, 2005.

<sup>5</sup> Two of the detailed operational guides to PPP which the author has found useful are Michel Kerf *et al*, *Concessions for infrastructure – A guide to their design and award*, World Bank Technical Paper No. 399, 1998 and Akintola Akintoye *et al* (ed), *Public-Private Partnerships – Managing risks and opportunities*, Blackwell Sciences, 2003.

<sup>6</sup> For an example of the complexities of a PPP project, see the reports of the UK House of Commons Public Accounts Committee (hereafter UK PAC) and the UK National Audit Office (hereafter UK NAO) on the Norfolk and Norwich Hospital refinancing arrangements. (respectively *Norfolk and Norwich Hospital – The refinancing*, House of Commons Committee of Public Accounts, Thirty-fifth report of session 2005-2006, House of Commons, 3 May 2006 and *The Refinancing of the Norfolk and Norwich PFI Hospital: How the deal can be viewed in the light of the re-financing*, Report of the Comptroller and Auditor-General, HC 78, Session 2005-2006, 10 June 2005. By way of explanation, though many of the examples in this book are drawn from the UK experience, this, as will be clear at several points, should not be interpreted as representing the author's unqualified approval of the UK approach to PPP. Rather it reflects the predominance of the UK in the European PPP market, with, at the time of writing, more than 800 contracts concluded.

and of lenders who finance PPP in the planning, procurement and contract management elements of the PPP. No public authority wishing to enter into a PPP should forget that there will be no transaction unless:

- The private sector partner can make a profit commensurate to the risks it is assuming
- Lenders are willing to lend to the private sector partner to the extent that the transaction is privately financed.

The book falls into six parts.

Chapter 1 attempts to explain the PPP phenomenon i.e. what it is, how and why it has emerged and attempts to set out a road map for public officials trying to understand the key issues in its use. The road map is not intended to be an executive summary of the entire work, though it does serve as an overview for any reader who wishes to gain an initial understanding of this field.

Chapter 2 sets out the issues associated with the management of a national PPP programme.

Chapter 3 analyses key issues in the current PPP policy framework

Chapters 4 and 5 describe and analyse the current legal framework for PPP and the operational approach to a PPP from the point of view of the public sector, and also how the PPP market is seen by private sector suppliers and financiers.

Chapter 6 highlights the importance of the role of auditors in ensuring the effective implementation of PPP – where audit fits in to the implementation process, why external audit matters and the key issues for effective PPP audit.

Finally, Chapter 7 attempts to draw together the key conclusions for the

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<sup>7</sup> *Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the co-ordination of procedures for the award of public works contracts, public supply contracts and public service contracts and Directive 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sector.* This book principally deals with the issues arising in Directive 2004/18 i.e. the Directive relating to public contracts (hereafter referred to in the notes as Directive 2004/18).

<sup>8</sup> The book is not intended, however, to be a definite textbook on the Public Procurement Directives. This need is more than adequately met in other sources. See, for example, Christopher Bovis, *EC Public Procurement Case Law and Regulation*, Oxford University Press, 2006 and Sue Arrowsmith, *The Law of Public Procurement and Utilities*, Sweet and Maxwell, 2005. The Public Procurement Directives are explained and discussed, however, where their application impacts upon the implementation of PPP.

<sup>9</sup> i.e. the assurance that the process will, if conducted according to known and well defined rules, lead to an outcome which is unlikely to be successfully challenged.



future of PPP in the context of the need for the more effective policy making, more effective implementation of PPP, an enhanced role for auditing and for better and more effectively enforced legislation and how they may impact on competition for PPP projects, value for money in them and maintaining public policy choice. Taken together, they add up to an agenda for reforming the implementation of PPP in Europe.

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<sup>10</sup> Defined, for example by the Treasury in the UK, as “the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user’s requirement”. In this context, whole-life costs can include, in addition to the costs of design and construction, the costs of service operation, asset repair and maintenance, user support, user training, supply of materials and cost of decommissioning/disposal. By way of explanation, in the author’s view, the idea that the objective of public procurement, and hence PPP, should be anything other than value for money for the public sector needs no justification. Nor does the fact that this can best be obtained by using a transparent and competitive form of procurement appropriate to the significance of the transaction. In the case of PPP, because of their value and thus relevance to the principles of the EU Internal Market, a transparent and competitive form of procurement means EU-wide advertising and the definition of requirements calculated to stimulate potential interest from the maximum number of potential providers with the capability to fulfil those requirements in a manner which does not discriminate against non-national providers. If further justification is required for transparent and competitive procurement, it can be amply provided by a Commission study which highlighted the fact that prices paid for contracts were 30% higher where the Public Procurement Directives were not applied than when they were applied. See *A report on the functioning of public procurement markets in the EU: benefits from the application of the EU directives and challenges for the future*, European Commission, February 2004.

# CHAPTER 1

## The PPP Phenomenon

### OVERVIEW

PPP have become a widely used term to describe different types of contractual arrangement. It is a term characterised by a lot of acronyms and titles.<sup>11</sup> But, as the IMF has recognised,<sup>12</sup> there is no clear agreement on what constitutes a PPP.

This chapter explains what PPP are, why they are being used, why it is important for decision makers to understand them and highlights for decision makers the emerging themes which are common to effective management of PPP and which need to be actively and consistently addressed in a dynamic environment. These themes are then further developed later in the book.

### WHAT ARE PPP?

The absence of a common legal definition is not a barrier to the effective use of PPP. As noted above, PPP are a form of public procurement, one which is usually complex with a lengthy selection process and often resulting in a long and high value contract. Thus, what is important for decision makers is to understand the legal framework for public procurement and the key commercial and operational issues arising in the implementation of that framework in practice.<sup>13</sup>

In fact, there are possible risks in succumbing to the temptation to attempt to develop a common legal definition of PPP.

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<sup>11</sup> For example, the UK Private Finance Initiative (PFI) is a form of PPP, as is the Betreibermodell in Germany.

<sup>12</sup> *Public-Private Partnerships*, IMF Fiscal Affairs Department, March 2004, p. 6.

Firstly, in a dynamic environment where PPP are being used for an increasing number of services and different forms of transactions are evolving, it is inevitable that any legally based definition is likely to be outdated even before it is enacted.

Secondly, and more importantly, it may lead some public authorities to be tempted to think that PPP can be procured by means other than those prescribed in the Public Procurement Directives and may indeed lend encouragement to those who wish to avoid the most transparent possible application of the Directives in such a PPP procurement.

If a definition is required, PPP may be defined as “a contractual agreement between a public entity (national, regional or local) and one or more (normally) private sector supplier(s). Through this agreement, the skills and assets of each sector (public and private) are shared in the creation of an asset or facility and delivering a service for the benefit of the general public. In addition to the sharing of resources, each party shares in the risks and benefits arising from the delivery of the service and/or use of the facility”.

From a financial perspective, PPP normally fall into three categories, namely:

- Free-standing PPP, in which the cost of the project is financed by end user charges
- Partly free-standing PPP, in which the cost of the project is financed by a combination of end user charges and payments by the Contracting Authority
- Public service PPP, in which the user does not pay for the service at the point of consumption, and the payment comes directly from the public sector budget.

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<sup>13</sup> This is not a text about the relative merits of partnership as a means of working, the benefits of which it has become fashionable to advocate. The author regards it as a given, however, that any public authority, whatever the form of partnership it intends to enter into, should, before doing so, follow the process of determining its strategic objectives, its priorities within those objectives, assessing which objectives can best be achieved by partnership and which not and then determining the specific outcomes it seeks to achieve from an individual partnership. In short, partnership is not an end in itself but is one of a number of means of achieving objectives. This applies as much to PPP as to any other type of partnership. As noted below, clarity of objectives and means of achieving them on the part of the public sector in a PPP is, arguably, particularly important because of the greater experience of the private sector in negotiating the terms of contracts than the public sector. Those interested in the wider issues of partnership as a means of service delivery may also usefully refer to *Governing Partnerships – Bridging the Accountability Gap*, published by the UK Audit Commission in October 2005.

Free-standing PPP and partly free-standing PPP have a long history, for example with toll roads in France, Italy and Spain. They are often called concessions, which are a form of PPP. Public service PPP are, however, becoming increasingly more common and underpin the significant expansion of PPP in Europe. Hence this book mainly focuses on issues from the perspective of public service PPP, though much of it is also relevant to other types of PPP.

Some of the specific terminology encountered in PPP includes:

- Build-Own-Operate (BOO), where a private partner designs, constructs, finances, maintains and operates an asset for performing public services without transferring ownership of the facility to the public sector i.e. legal title to the facility remains with the private sector partner
- Buy-Build-Operate (BBO) i.e. a form of asset sale that includes the rehabilitation or expansion of an existing asset providing public services. The public entity sells the asset to the private partner, which then makes the improvements necessary to operate the facility in a more cost effective manner and, again, legal title remains with the private partner
- Build-Operate-Transfer (BOT), in which the private partner designs, constructs and finances an asset to the specifications set by the public entity and maintains and operates it for a specific time period under a contractual agreement. Title to the facility is with the private partner during the period of the contract but reverts to the public sector at the end of the period
- Design-Build-Finance-Operate (DBFO) is another term used for arrangements similar to a BOT.

The typical features of a public service PPP transaction are:

- The creation and/or re-development of an asset by the private sector supplier. This can, for example, be a road, a bridge, a school or a hospital, normally using land and/or buildings which are publicly owned before the PPP
- The use by the same private sector supplier of the asset created or re-developed to provide a new or existing service to the public over a defined period of time. This period is often longer – it may be up to 30 years or longer – than is customary in other public contracts
- The payment of a periodic charge to the supplier by the public entity for the provision of the service using the asset rather than a capital sum for the construction of the asset.<sup>14</sup> The periodic charge may vary according to the volume of service supplied<sup>15,16</sup>
- The absence of a commitment by the public entity to pay the periodic charge until and unless the asset is being used in the provision of the

- service
- The sharing of the risks and benefits of the outcome of the project by both partners
- PPP share with other forms of procurement the fact that the public authority is responsible for defining the scope, quality, time scale, means of service delivery and in some case prices for the service.

The process by which a typical PPP is constructed is, in essence, as follows i.e.

- A public entity awards a contract to private sector partner. This will typically be a consortium including a construction company, a service provider and a financial institution (whose role will include ensuring that the transaction's financial structure meets the interests of the consortium's investors)<sup>17</sup>
- The private sector partner/consortium creates an ad hoc company or Special Purpose Vehicle (SPV) to operate the contract. This is the entity which contracts with the public sector
- The SPV is financed from equity capital invested by the private sector partner/consortium and from borrowings. The percentage of equity capital – private or public sector – varies from state to state according to their financing preferences and to some extent their capital markets. Borrowings can typically be up 85% to 90% of the total financing, so lenders, providing the majority of the finance for PPP transactions, clearly have most to lose if the project is unsuccessful
- The SPV sub-contracts the construction and maintenance of the asset and operation of the service. The sub-contractors to the SPV will in many cases be the investors. A construction company will generally invest in a PPP because they are seeking the contract to construct the asset and a service provider will invest because it wants to operate the

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<sup>14</sup> The periodic charge is sometimes called the “unitary charge”. The payment flow for a PPP, avoiding a lump of upfront capital expenditure, is one of the attractions of PPP for governments facing budgetary constraints. This is particularly true if the borrowing to finance the PPP is undertaken by the private sector and meets the conditions for excluding it from the government balance sheet.

<sup>15</sup> Thus the periodic charge may include both an availability element and a demand-related element.

<sup>16</sup> In a concession, of course, the service provider receives income from the public as end users. In a partly free-standing PPP, the payment from the Contracting Authority could be a subsidy per user or a fixed periodic charge – an availability payment – which enables the charge to the end user to be reduced.

<sup>17</sup> The fact that contracts are such a size and complexity that bids are likely to come from consortia may reduce the degree of competition available to a public authority.

service/maintain the asset. Legally however, they are sub-contractors to the SPV, and of course they will use their normal supply chains to actually deliver the construction/maintenance/operation activities through further sub-contracting

- The periodic charge is paid by public entity to the SPV
- The SPV uses this income to repay its loans to its senior lender (which in the financing structure of privately financed PPP will take generally precedence over all other forms of finance) and pay dividends to its shareholders.

This short description masks the complexity of the contractual arrangements between the various parties to a PPP, whose roles are set out in more detail in Chapter 5 below.

The definition above, and the list of features, has the merit of highlighting four of the essential elements of a PPP, namely that:

- The objective of a PPP is a partnership between the public and private sectors to deliver services to the public, which is how PPP have been characterised by the European Commission<sup>18</sup>
- PPP involve a transaction embracing both the creation of an asset and the use of that asset to deliver services. The logic of this transaction structure is that it is likely to optimise the efficiency of design, construction, operation and maintenance of the asset if:
  - The private partner does not get paid until the asset is first available for use to deliver the service
  - Even after the service delivery has commenced, the private partner is not paid for periods when the asset is not available for use in whole or in part (e.g. the whole of a building, or some rooms within it, to take the case of a school, hospital, prison or office accommodation) in the condition agreed in the contract
  - The private partner responsible for design and construction of the asset is then required to operate and maintain it for a fixed price (bid for competitively), thus avoiding the temptation to minimise construction costs in a way which leads to higher operation and maintenance costs and thus higher overall whole life costs
- The public and private sector partners share the risks of the transaction. This requires that the type of risks, the likelihood of their occurring and the consequences of their occurring are more explicitly identified than has often been the case in the past.<sup>19</sup> This is necessary so that the burden

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<sup>18</sup> For example in *Guidelines for Successful Public-Private Partnerships*, European Commission, Directorate-General for Regional Policy, March 2003, p. 16.

of the risk is allocated to the party best able to bear them (in the sense of being able to anticipate, control and manage the risks) and the cost of bearing the risk can be taken into account in determining the cost of the service. Risk allocation and valuation are a crucial element in assessing the extent to which PPP represent the optimal solution for a particular need. In spite of the uncertainties in the process, it is clear benefit of the PPP transaction structure that it imposes the discipline of identifying and assessing potential risks

- It is a contractual agreement which sets out the rights and responsibilities of both parties. One of the key issues in assessing the appropriateness of PPP for a particular transaction is the extent to which the outputs of the contract can be specified with sufficient precision and are sustainable i.e. the extent to which, and the period for which, a service is “contractible”.

Thus in the currently evolved structure of PPP transactions, a public authority makes long-term financial commitments to the private partner which are guaranteed provided that the service is delivered as specified. These commitments to the service provider are linked to the demands of the lenders who provide long term loans for the projects, after undertaking a technical and commercial examination of the risks in the transaction (known as due diligence).<sup>20</sup> This is because most PPPs are financed on a so-called “non-recourse” basis (or perhaps – given the measures taken by lenders to secure the repayment of their loan<sup>21</sup> – better described as a “limited recourse” basis) i.e. the lender does not have the right to secure repayment of project loan from the assets of the companies investing in the service provider. Their main security for repayment is the revenues of the project, hence these revenues need to be robust from the lenders’ point of view. This is underpinned by a large number of detailed sub-agreements. Indeed, it is not uncommon for the totality of a PPP to comprise more than 100 separate

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<sup>19</sup> This is often done through the formal process of preparing a risk register. Such a process is valuable and necessary in spite of the uncertainties in identifying the probability of risks occurring and the valuation of consequences of such events and the fact that this may lead to an attempt to be over-precise in the valuation of such risks.

<sup>20</sup> In the current market model, the loan period is usually less than the contract length, since lenders in general want a “tail” of guaranteed revenues for the service provider beyond the period of loan repayment as a form of insurance against the possibility that project revenues may not be as high as expected. For example, in a 25 year contract, the loan repayment date might be after 20 years (unless of course there is a refinancing arrangement for early repayment of the loan. The financial implications of debt refinancing are explained below, see p. 61).

<sup>21</sup> See below, pp. 59-60.

agreements.

This means in practice for the public sector that:

- If the Contracting Authority wishes to change the service requirement there will almost inevitable be financial consequences i.e. a higher amount to pay if new or changed services are required, or a higher standard is required, but there is also often likely to be a commitment on behalf of the public authority to make a minimum guaranteed level of payments even if it no longer requires all or part of the contracted services
- Lenders will in many cases seek to cap the level of deductions from the periodic charge even if the service is being provided to a standard defined in the contract as unsatisfactory, again to secure their repayments
- Lenders will often require that, even if the public authority wishes to terminate the contract because of the poor performance of the service provider, the public authority may be liable to make a termination payment to the service provider for the benefit of the lender. This is a fundamental difference from conventional procurement.

These issues create a significant degree of “lock-in” on the part of public authorities, which should at least lead to pause for thought in determining the suitability of a service for PPP.

This description of the features of a PPP highlights that, unlike in conventional procurement where there are two parties, the Contracting Authority and the service provider, in a PPP there is usually a third party, the lender, whose needs have a significant impact on the shape of a transaction.<sup>22</sup>

There are in fact several variations in the detailed financing structure of a PPP transaction. PPP can, for example, be publicly or privately financed or financed by a mixture of both,<sup>23</sup> the private finance will be a mix of debt and equity, the debt can be of different kinds i.e. fixed rate, floating rate or index linked or from different sources i.e. from private sector banks or from the European Investment Bank, or provided by bank lending or bonds (which may be insured or not) and debts can be different degrees of priority and security (e.g. senior debt and mezzanine debt).

The financing of a transaction is a very important judgement because of the influence that providers of finance have. Pressures on public budgets and

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<sup>22</sup> The predominance of the needs of the lenders is also a feature of particular national variants of PPP, such as, in Germany, the Forfeiting model, the Bund model and the Mogendorfer model. These are described in *A Practical Guide to PPP in Europe*, Maurice Button (ed.), City and Financial Publishing, 2006, pp. 127-128.

<sup>23</sup> It would be a too narrow definition of PPP to restrict it simply to transactions which are privately financed, in spite of the fact that many are.



the widely discussed difficulties of integrating the use of EU Structural Funds into PPP may lead public authorities in the direction of private finance i.e. the use of private finance may simply be a question of the inability to finance a project from public budgets and the manageability of the process. If mixed public and private finance is used, a public authority needs to be aware that the interest of the private lender is to protect the security of *their share of the lending* and not necessarily the overall viability of the project. Thus, if a project is financed to a significant extent by public finance (e.g. grants, loans or equity in the SPV or credit support for revenue shortfalls), the public authority must consider how the contract reflects the distribution of losses on early termination in the event of the failure of the service provider. In short, the public sector will need to protect itself from taking an undue share of any losses.

PPP can also embrace different models of asset ownership i.e. either the public sector or the private sector supplier could own the asset being used to provide the service during the contract period. If it is owned by the private sector supplier during the contract period, at the end of the contract period the asset could revert to public sector ownership automatically and at nil value, remain in the ownership of the private sector supplier or the public entity may have the option or obligation to re-acquire it at the end of the contract.

The ultimate ownership of assets is a key decision which needs to be made in determining how to deliver a public service. This is because inability to recover assets is a key barrier to a public authority having an exit strategy which, as noted below in Chapter 2, is a key element in maintaining value for money in a transaction. This issue can most effectively be dealt by arrangements which:

- Leave the asset in the ownership of the private sector during the life of the contract, with an obligation on the service provider to maintain it to a given standard and return it in a fit for purpose condition without payment at the end of the contract and with a post contract warranty (for, say, two years), or
- Provide that the public sector acquires the asset at the end of the contract at an independently determined market value (i.e. reflecting condition) at the time.<sup>24</sup>

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<sup>24</sup> This decision would clearly have to be made at the time of awarding the contract, because, in the second case, the end of contract payment would form part of the overall receipts of the service provider.

It would be easy to assume that, because this is the transaction structure which has evolved and is established, there is no other way in which all the elements of it could be structured. It is an attitude which, in the author’s experience, professional advisers, whose interest is in “deal flow” – that transactions should happen rather than not happen, and paying less regard to the medium and long term value for money interests of the public sector – have an interest in propagating. In describing this structure, the reader should not assume that the author is of the opinion that it was inevitable or, more importantly, is immutable. As is clear from a brief understanding, there are some aspects to it which may lead the reader to conclude that the current structure of privately financed PPP is inherently disadvantageous to the public authority for some services.

For the sake of completeness, it may be noted that the term PPP is also sometimes used to describe transactions which are essentially about economic regeneration, such as the use of publicly owned land for residential and commercial development, and, within the residential category, both private and social housing, and variants such as the creation of innovation clusters through co-operation between public authorities, universities and the private sector.

The author does not, however, consider that any purpose is served by a theoretical debate about what kind of transaction does or does not constitute a PPP, subject to the proviso that there is a single contract for the creation of an asset and the provision of a service using it. Many of these transactions in any event fall within the category of the creation of an asset and the provision of service within the same contractual arrangement e.g. a public authority might require that the private partner in a mixed residential development constructs and maintains an element of social housing or refurbishes and maintains office accommodation for the use of the public authority in parallel with the development of office accommodation for commercial letting and/or for retail use.

## **WHY IS IT IMPORTANT TO UNDERSTAND PPP?**

Transactions which correspond to the features of a PPP have existed before the term came into use in the 1990s. But there are six main reasons why, more than ever, it is now important policy makers and those responsible for public service delivery to understand PPP.

## **There are strong pressures both in old and new EU Member States driving public authorities to use PPP as a means of delivering public services**

There are strong pressures both in old and new EU Member States driving public authorities to use PPP as a means of delivering public services e.g. budgetary pressures (whether in or out of the euro zone) leading to the need for cost reduction, better revenue collection and financing of infrastructure investment and pressures from citizens as consumers with ever higher service expectations. In some cases public entities seek also to use PPP as a way of introducing private sector management skills for different methods of service delivery and use public assets more effectively.

## **PPP are important to the implementation of EU policies and will be for the foreseeable future**

From a European perspective, one consequence of the budgetary pressures is a “funding gap” between the financing needed to implement the policies and the public funds available e.g. by completing the Trans-European Networks (TENs),<sup>25</sup> and enabling Member States, and particularly the new Member States, to comply with EU environmental legislation, which often have specific deadlines for implementation.<sup>26</sup>

## **PPP are often politically sensitive transactions**

This is clear from the often high profile nature of the services for which PPP are frequently used (transport and energy links, environmental services, transformation of education and health etc.) and from the fact that PPP transactions are often also complex i.e. a lengthy selection process leading to a

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<sup>25</sup> A programme of Europe-wide transport networks, principally designed to facilitate the free movement of goods across the EU, defined at the European Council in Essen in 1994.

<sup>26</sup> See, for example, *Developing Public Private Partnerships in New Europe*, PricewaterhouseCoopers, 2004, pp. 7-8 and p. 10. The amounts estimated for implementing the environmental legislation in the new Member States in conformity with European standards range from €80-110 billion or around 2% of GDP for a sustained period. A report published by the European Commission assessing the costs of completing the Trans-European Transport Network (TENs-T) priority projects estimated costs of €600 billion up to 2020.

long and high value contract. Hence the opportunities and risks are correspondingly greater than in other public procurements. It is therefore important to know when they are the appropriate solution and how to implement them effectively both operationally and commercially.

### **PPP are a dynamic field of activity**

PPP are becoming ever more widely used across the EU – UK, Ireland, Italy, France, Portugal and Spain already have high or rapidly growing levels of activity in different sectors. Other Member States represent “emerging markets” for PPP where, after a cautious start, in some cases caused by the need to remove legal and administrative barriers, PPP are becoming increasingly widely used. These include Germany, Austria, the Netherlands and Greece.<sup>27</sup>

The list of services for which PPP has been used becomes ever longer. At the time of writing, and in no particular order of priority, PPP are currently being used in at least one EU Member State for services as diverse as water supply/wastewater treatment, solid waste management, energy, telecommunications, transportation (rail, metro, roads, traffic management), highway maintenance, street lighting, urban development (including social housing), schools, hospitals/health care, social care, office accommodation, leisure facilities, defence, IT services, criminal justice (prisons, courts), air traffic control, training, research and development, property management and environmental management.

### **PPP transactions are for the long term**

PPP transactions are for the long term, typically 20-25 years or more. So there is a need now to try to understand the medium and long term political

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<sup>27</sup> The removal of legal barriers to PPP is a significant issue which has started to be addressed in many EU Member States. This has included, in different national jurisdictions, for example, overcoming a requirement to let separate contracts for design and construction and operation of services, the lack of legal power to pledge state assets as security for a transaction, taxation charges arising on the transfer of assets between the public and private sectors, specification of the mix of debt and equity financing in a PPP, statutory obligations on behalf of the state to deliver services (as opposed to arrange for their delivery), restrictions on long term budgetary commitments in public finance law, lack of legal powers to grant step-in rights to lenders and the lack of a legal power to create an SPV to act as service provider.

and economic effect of PPP as a means of public service delivery i.e. the implications for public service delivery of the wider use of the private sector as a service deliverer.

In most sectors and Member States, a majority of public services are still delivered directly by the public sector, so any conclusions must by definition be provisional. But two developments can be observed where there has been wider use of the private sector for service delivery.

Firstly, where the public sector has withdrawn substantially or completely as a service provider there can be difficulties in some cases for public entities to regulate the sector effectively. This has been observed in the provision of long-term residential and nursing care for the elderly, chronically ill and physically disabled in the UK, where sub-national government is now heavily dependent on the private sector for the provision of this care. As a result, and because of the sensitivity of the need to avoid complete service failure, the government's attempts to introduce new standards for staff training and staffing ratios and standards for accommodation had to be significantly modified because of pressure from market providers.<sup>28</sup>

Secondly, market liberalisation has led to consolidation amongst potential private sector providers. This has been observed within the EU in the private sector provision of water, energy, solid waste management and prison management sectors. One consequence could be potential future difficulty for public entities to have access to continuing effective competition for individual contracts, particularly when combined with a high level of activity and thus the opportunity for the private sector to select which opportunities it responds to.

It is too soon to say whether or not generally there ought to be concerns about the value for money of PPP in the long term i.e. over the life of the transaction, though bodies such as the UK National Audit Office have, in some high profile cases such as the London Underground PPP, found it difficult so far to assess how likely this is to be the case.<sup>29</sup> Very few PPP have gone the full course of their life. But those who claim that PPP have already

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<sup>28</sup> See *NHS plc – The Privatisation of Our Health Care*, Allyson Pollock, Verso, 2004, p. 157 *et seq.*

<sup>29</sup> *London Underground PPP: Were they good deals?*, Report by the Comptroller and Auditor-General, HC 645 Session 2003-2004, June 2004, p. 2, pp. 25-26. These contracts incorporate break points every 7.5 years of what are 30 year contracts. It remains to be seen whether or not the public sector Contracting Authority, can maintain value for money through these break points, even with the use of a PPP arbiter, given concerns expressed at the time of the contract award that the private partner would have an advantage in terms of the information available in the negotiations at the time of the break points.

delivered value for money savings are by definition basing their claims on savings foreseen in PPP transactions negotiated and/or savings claimed to have achieved during the project construction phase.<sup>30</sup> A more useful assessment of value for money for a public entity can in reality only be made over the whole life of the transaction.<sup>31</sup>

### **There has been and continues to be a wide ranging review of the legal framework for PPP**

The latest update of Public Procurement Directives occurred in March 2004 – a process which took nearly four years to complete from the date of the original Commission proposal for draft directives – and the deadline for their transposition into national law was 31 January 2006.

However, the conclusion of the legislative process for the Public Procurement Directives marked only the start of a process which could lead to further changes in the legal framework for PPP.

The key recent developments since that date have been:

- The publication by the European Commission of a consultative Green

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<sup>30</sup> The willingness to claim that PPP deliver value for money based on comparison between bid values negotiated and the claimed cost of public sector provision is well established. See, for example, the report commissioned by the Treasury PFI Task Force from Arthur Andersen and Enterprise LSE, *Value for Money Drivers in the Private Finance Initiative*, January 2000, and quoted in *Public Private Partnerships – The Government’s Approach*, Her Majesty’s Stationery Office, 2000, p. 17. In fairness to the authors of the original report, they also go on to say that “the operational benefits of PFI will take much more time to establish...The long term value for money of PFI projects will depend on how well the private sector manages the risks transferred to it and the public sector’s success in managing the contracts over their duration”. But in the citation noted above, and in other citations, this elaboration is not always presented so explicitly. It also raises the question about the continuing relevance of the comparisons in the UK context even about the construction phase, given that much of the evidence of conventional procurement used in them occurred before, or shortly after, the establishment of OGC to improve government procurement. The recent improvement in government procurement generally, reducing the frequency of time and cost overruns was noted in a recent UK NAO report *Improving Public Services through better construction*, Report of the Comptroller and Auditor-General, HC 364-II, Session 2004-2005, 15 March 2005.

<sup>31</sup> Though opinion surveys of participants in the PPP process are generally to be treated with some caution, it was noted by the UK NAO that 23% of Contracting Authorities surveyed by them in 2001 believed that value for money had declined during the contract execution phase. See *Managing the relationship to secure a successful partnership in PFI projects*, Report of the Comptroller and Auditor-General, HC 375, Session 2001-2002, 29 November 2001, p. 33.

Paper in April 2004<sup>32</sup>

- The publication of the results of the consultation in May 2005<sup>33</sup>
- The publication of the political conclusions arising from the consultation in a Commission Communication in November 2005<sup>34</sup>
- The launch of further impact studies re the legal framework for PPP
- An Explanatory Note from the Commission on Competitive Dialogue published in January 2006
- Proposed amendments to Public Procurement Remedies Directives in May 2006.<sup>35</sup>

The key features of these recent developments are that:

- Two new terms were introduced to the language of PPP i.e. Contractual PPP and Institutional PPP (“IPPP”):
  - Contractual PPP are characterised as a contractual agreement between a Contracting Authority and a supplier to deliver a service e.g. a concession to the provider with charges to the user (with or without additional subsidies from Contracting Authority) or a PFI with regular payments to the supplier from the Contracting Authority. PFI – the Private Finance Initiative – is the name often given to PPP in the UK
  - Institutional PPP are characterised as the establishment of an entity held jointly by Contracting Authority and private partner to deliver services back to the Contracting Authority and, in many cases, also to third parties. The Commission refers to the establishment of an IPPP as occurring either by creation of a new entity or transfer of an existing public sector entity to the private sector. The terminology is useful, though it does not cover all the range of possibilities e.g. an IPPP could have a majority public sector shareholding, a minority public sector

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<sup>32</sup> *Green Paper on public-private partnerships and Community law on public contracts and concessions*, COM(2004) 327, European Commission, April 2004 (hereafter referred to in the notes as “the PPP Green Paper”).

<sup>33</sup> *Report on the public consultation on the Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions*, Commission Staff Working Paper, SEC (2005) 629.

<sup>34</sup> Communication from the Commission to the European Parliament, The Council, The European Economic and Social Committee and the Committee of the Regions on Public-Private Partnerships and Community Law on Public Procurement and Concessions, COM (2005) 569, European Commission, November 2005 (hereafter in the notes “the PPP Communication”).

<sup>35</sup> *Proposal for a Directive of the European Parliament and the Council amending Council Directives 89/665/EEC and 92/13/EEC with regard to improving the effectiveness of review procedures concerning the award of public contracts*, COM (2006), 195 final, European Commission, May 2006.

shareholding or have equal shareholdings, all of which could change during the entity’s life. In doing so it also raised the question of how the private partners should be selected for IPPP

- It is not yet clear to what extent this process will change the legal framework for PPP, but the nature and scope of the process, and the issues which it addresses mean that change is likely.

For example, it is clear, following the Commission Communication of November 2005, that:

- There will be no proposal for new legislation covering all contractual PPP, i.e. that there will not be separate PPP legislation introduced to the EU legislative framework which is distinctive from that for public procurement
- The award procedure for PPP which are classified as public contracts and those which are classified as concessions will not be standardised
- There will be no proposals to extend the legislative framework to cover the execution phase of PPP contracts
- There will be no proposals to classify certain services, for example health and education, which are now increasingly provided through PPP, as being subject to the full regulation of the Public Procurement Directives.<sup>36</sup>

In the PPP Green Paper the Commission addressed the key question of whether or not different award procedures can be justified for PPP classified as public contracts and those classified as concessions. It also highlighted that in some transactions it has not been easy at the start of an award process to be sure whether they are a public contract or a concession and that the initial definition might change as a result of negotiations<sup>37</sup> But, having developed the analysis, it then concluded in the Communication<sup>38</sup> that there was “significant stakeholder opposition to a regulatory regime covering all contractual PPP” (public contracts *and* concessions) and therefore “the Commission does not envisage making them subject to identical award arrangements”.

Elsewhere in the Communication<sup>39</sup> there is a recognition of the need for a stable, consistent legal environment for the award of concessions, particularly to enhance competition, that general EU treaty principles do

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<sup>36</sup> These are currently classified as “non-priority or Part B services” (because they fall into the categories defined in Annex IIB of Directive 2004/18). They are subject only to rules on the need for non-discriminatory technical specifications and publicity about the award through the publication of contract award notices.

<sup>37</sup> *The PPP Green Paper*, p. 12.

<sup>38</sup> *The PPP Communication*, p. 5.

<sup>39</sup> *Ibid*, p. 7-8.



not provide enough legal certainty in the award of concessions and that it is “difficult to understand why service concessions which are often used for complex and high value projects are entirely excluded from EU secondary legislation”.

There is in fact little justification for these different treatments for PPP which are public contracts and those which are classified in the Directive as concessions – Treaty principles themselves do not provide sufficient justification and nor does the potential existence of additional risk to the supplier in a concession.

The existence of different procedures also creates opportunities for the avoidance of transparency and competition in procurement in the way that the contract is structured, especially as many PPP are capable of being classified as service concessions. This avoidance of transparency and competition in procurement could have an impact on the ability of public authorities to procure infrastructure development at a price which represents optimal value for money.<sup>40</sup>

The author’s view is that the most straightforward way of bringing about legal certainty in this field is the solution which the Commission appears to have ruled out i.e. making public contracts and all concessions subject to identical award arrangements. In effect this would render the distinction between public contracts and concessions redundant

- Significant issues still remain about how the Competitive Dialogue procedure should be implemented in practice.

The Commission’s Explanatory Note of January 2006 was a useful contribution to the application of the procedure though it does not answer all the questions which will arise in practice about the implementation of Competitive Dialogue – many of these will be resolved as the procedure is used in practice. In particular, it does not elaborate on what changes will be permitted to offers in discussion with tenderers.<sup>41</sup>

The issues associated with the legal framework for PPP are discussed further below in Chapter 4.

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<sup>40</sup> For the same reasons – i.e. the need to avoid a multiplicity of procedures – sectoral and sub-national legislation is also undesirable.

<sup>41</sup> i.e. it does not define what is permitted by the terms “clarify, specify and fine tune tenders” or “clarify aspects of the (winning) tender” and “confirm commitments in the (winning) tender” referred to in Art 29, Directive 2004/18.

## **WHEN ARE PPP LIKELY TO BE AN APPROPRIATE SOLUTION?**

It is not possible to be absolutely definitive about when PPP are the most appropriate solution for delivery of public services from the point of view of the public sector and best practice suggests that this should be determined on a case by case basis. But it is possible to identify a number of factors which make it more rather than less likely to be suitable.<sup>42</sup>

Free standing and partly free-standing PPP, where there is income directly from user charges, are obvious candidates, though municipalities need to ensure that, in the case of schemes in the cultural and sporting sector, the business plans for them are sound, to avoid the risk that the municipality may involuntarily have to take over the service provision directly. It is therefore no accident that PPP in many countries have started in the transport sector.

For public service PPP, relevant indicators include relative ease and precision of specification of service requirements,<sup>43</sup> ease of measurement of performance and services for which the technology is well established and well understood. Another key requirement is the extent to which service needs are likely to change materially over the length of a long PPP contract. These criteria tend to suggest accommodation schemes, and particularly municipal social housing, can be suitable candidates for PPP, more so than, say, clinical services or even more so for ICT services where there is or may be the additional risk of interface issues between the delivery of contracted services and the underlying service delivery issues and/or the interface with legacy systems and contracts.

Similarly, where, as with roads for example, construction costs are a significant proportion of the total costs over the life of the PPP contract, the impact for a public authority associated with changing the service requirements is likely to be less significant than is the case of services where operating costs – often personnel driven – are a high proportion of total costs.

The sustainability of risk transfer is also important in determining the suitability of a service for PPP, because the valuation of risks transferred in a PPP from the public authority to the private sector partner are a key element in assessing the extent to which PPP represent the delivery route most likely to deliver value for money.

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<sup>42</sup> The value of the transaction can also be a factor, given the relative complexity of, and time needed for, the procurement of a PPP. These considerations have led in the UK, for example, where the average time for a PPP procurement exceeds two years, for PPP not be generally be used for schemes with a total value of less than 20 million (c.€30 million).

<sup>43</sup> Sometimes, as noted above, referred to as the extent to which a service is “contractible”.

A public authority needs to be assured that the risks transferred and paid for by it will not revert to them during the life of the contract, should things go wrong.

This may seem clear, if, for example, PPP were to be used for the construction, operation and decommissioning of nuclear power stations,<sup>44</sup> where the cost of decommissioning is very difficult to quantify and the cost of an incident (by accident or terrorist activity) virtually impossible to measure. It can, however, also arise in any circumstances where a public authority needs in practice to intervene in a service to assist a private sector partner in financial difficulties (even though it is not legally obliged to do so) because it cannot accept the consequences of short term service failure. It might also happen in a road or rail concession if, for example, traffic volumes are lower than forecast and the demand risk has been transferred to the private sector partner (i.e. no minimum revenue guarantee has been given to the concessionaire) and the government cannot afford for the route to be closed in the short term. The greater the short-term criticality to the public authority of uninterrupted service provision, the greater the likelihood that this will happen.<sup>45</sup>

For decision makers consideration of the sustainable transferability of risk may lead to the conclusion that a particular project is not suitable for a PPP or that an individual risk which they seek to transfer is not genuinely effective and sustainable – and thus not worth paying for – unless service continuity can be maintained in the short term (however this is defined for a particular service) and that the public sector can make alternative service arrangements at no cost to itself.<sup>46</sup>

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<sup>44</sup> In the summer of 2006, the UK government was reportedly considering the option of using PPP for the construction of new generation of nuclear power stations. It is a matter of legitimate political debate on energy security, environmental, generation cost and safety grounds whether or not nuclear power stations should form part of the future mix of sources of electricity supply. But it is clear that if this were to be done by a PPP, the amount or risk transferred would be strictly limited to what the private partner could quantify and thus accept. Such a PPP would need to be underpinned by significant government guarantees.

<sup>45</sup> For example, the UK government could not accept the consequences of the financial failure of NATS – the private partner selected for the UK's air traffic control PPP in 2001 – which faced it after the significant reduction in air traffic after September 11<sup>th</sup>. It had to offer short term financial assistance to the company in order to create the space for a restructuring and refinancing arrangement. The decision to proceed with the particular financing structure of the NATS PPP was, incidentally, a good example of the way “optimism bias” can be used to justify a PPP. The business plan of the successful bidder was subject to sensitivity analysis, but only one of the ten scenarios used envisaged a fall in air traffic movements – and that only a small one – even though there had been two such significant falls within recent times i.e. after the 1973 and 1978/79 oil price shocks.

There are also some public policy considerations which make some services potentially unsuitable for PPP, though these will apply more at national than local level. It would, for example, clearly be undesirable for national defence, maintenance of internal security or maintenance of law and order to be the subject of a PPP.

Security of supply is another key judgement in determining the suitability of a project for PPP. This is most obviously true in energy supply. A PPP will have implications for determining the ownership structure and the way service delivery needs will be met, which are relevant considerations in assessing its suitability, where control of the supply passes outside the territorial market (which could be national or European). Recent concerns in the EU about gas and electricity supplies (availability of raw materials and network capacity management) have served to highlight this point.

## **PPP – ROAD MAP FOR A DYNAMIC ENVIRONMENT**

Because PPP are complex, often a high profile and a long and high value contract may result and they deserve proper attention and application of good procurement practice.

In any situation where there is complexity, it is useful for decision makers to be able to identify the high level issues which will influence whether or not the opportunities will be taken successfully. Used in appropriate circumstances and successfully implemented, PPP are capable of making a noticeable contribution to the development of the European infrastructure necessary to complete the EU Internal Market and, more generally, to provide an option available to administrations for the delivery of public services. These high level issues are explained below.

### **The need for legal certainty**

There is a need for reasonable legal certainty to attract sufficient competition for PPP contracts because they are high value and long-term.<sup>47</sup> As noted above, the legal position of PPP is fluid. Greater legal certainty and cross EU

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<sup>46</sup> Even if the transferability of a risk is sustainable i.e. it can be passed to the private sector with the reasonable likelihood that it will not revert to the public sector, the actual transfer of the risk needs to be sustained. This is discussed further in Chapter 5 in the context of contract management. For example, the public authority should not engage itself in the management of relationships between the main contractor and sub-contractors by intervening directly with sub-contractors.

consistency is needed beyond the new Directives because the inconsistency and uncertainty now in PPP procurement risks Internal Market fragmentation in an area, which has already been identified by the Commission as lagging behind in implementation.<sup>48</sup>

Legal certainty is particularly important in attracting interest in long term, high value contracts such as PPP, which often call for high levels of investment by service providers and long term financial commitments by Contracting Authorities.

### **The need for transparent and competitive procurement**

This derives from the pressures on public authorities. They need to procure significant infrastructure development as quickly as possible to comply with EU legislation and to meet the expectations of citizens as consumers with ever higher service expectations. When they are also faced with severe budgetary pressures it is particularly important to ensure that value for money<sup>49</sup> is achieved through transparent and competitive procurement.

### **Maintenance of future public policy choice**

PPP has the potential to lead to major change (much higher intensity) in the role of the private sector as a service deliverer. The appropriate use of PPP is important in all economies but there is a particular need to promote a proper debate in new Member States countries before they take decisions which may have a significant impact on their future financial and political choices.

In short, each EU Member State needs to have undertaken a clear assessment of the fiscal risks associated with PPP i.e. the affordability of annual payments committed to in PPP, the total estimated future liabilities incurred and the impact on future public borrowing capacity. Put simply, a liability incurred as a result of a PPP does not cease to be a liability just because the transaction is so structured as to ensure that the debt incurred does not appear on the government balance sheet, even though it may in the immediate term assist a government to comply with the fiscal rules which bind those EU Member States which are either in the euro zone, wish to join it or are committed by treaty to join it.

Each EU Member State also needs understand the supply market within

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<sup>47</sup> It is a given for PPP that there is a need for a stable legal and regulatory regime for the management of the contract.

which it is choosing to use PPP. As noted above, the retention of public sector delivery capacity i.e. management skills and the ability to recover people, physical assets and information assets are important to maintaining public policy choice.<sup>50</sup>

This goes beyond market assessment to active market management and the importance of public authorities understanding the need to control the market. They are potentially in a position to do so, given their significant power as buyers in many markets. In the UK, government spending represents 55% of all ICT spend and 31% of all construction spend.<sup>51</sup> This potential power needs to be realised effectively in order to counterbalance the inequality in the negotiating skills of the two parties. The private sector, by reason of frequency of engagement with PPP transactions, has far greater experience of such transactions than the public sector and thus potentially more ability to negotiate more effectively.

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<sup>48</sup> The Commission’s report on the functioning of public procurement markets – see note 10 above – drew attention to elements of the failure of implementation of the public procurement directives. The “transparency ratio” or the ratio between the potential value of public procurement subject to the EU Public Procurement Directives – i.e. about 16% of GDP – and the actual value advertised in the Official Journal of the European Union (OJEU), which is less than 3% of GDP. There are valid and invalid reasons why there might be a gap. Not all public procurement is subject to the advertising requirements of the Directives e.g. procurement below the thresholds in the Directives, exempt procurements, including the availability of exemptions relevant to the field of defence procurement, less regulated services etc. There are also tightly defined circumstances set out in the Directives where the use of the negotiated procedure without advertisement of the contract is permitted. But the gap may result from failure to advertise in accordance with the Directives, particularly where public bodies have misused the negotiated procedure without advertisement.

The second anomaly which the Commission has drawn attention to is the gap between the number of invitations to tender published and the number of contract award notices published. Currently, the number of contract award notices published in a year is only about 55% of the number of invitations to tender published. In principle, there should be a contract award notice corresponding to each invitation to tender. There can be good (or bad) reasons why there is not – a procedure can be cancelled after launch for valid reasons – and there can be clearly be a time lag between years. Often contract award notices do not include the value of the contract, thus frustrating the aim of greater price transparency and improved competitiveness. There is scope to develop better understanding of the reasons for the non-publication of contract award notices for launched tenders and improving the quality of information in contract award notices.

## The linkage between political objectives and procurement objectives

PPP are a means for public entities to achieve their policy objectives, so it is necessary before launching a PPP to ensure that, firstly, it will achieve an end compatible with policy objectives and secondly, that these objectives are not inconsistent with the objectives of other policy objectives and programmes.

## Need to assess use of PPP on a case by case basis

PPP are not the only way to achieve policy objectives and thus there is a need at the level of the individual public entity, to confirm that a PPP is the most appropriate solution in each particular project.<sup>52</sup>

PPP are not – or should not be seen as – the default option for a project. To regard them as such can lead to the risks of weakening the bargaining position of public entities with suppliers, possible over dependence of a public entity on the private sector for service delivery and/or stretching the capacity of the market to supply public sector needs.

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<sup>49</sup> Defined, for example by the Treasury in the UK, – see above, note 10 – as “the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user’s requirement”.

<sup>50</sup> The choice of an IPPP as the delivery vehicle for part of a PPP market can also help to achieve this effect, though there are risks which need to be managed even if the joint venture does not trade outside its geographical or sectoral area and there is a simultaneous transparent and competitive award procedure for the selection of the private partner and the award of the contract to the new entity.

These risks centre on the conflict of interest which can occur between the Contracting Authority’s role both as a service provider (as a partner in the IPPP) and customer, particularly where difficulties arise with the provision of the service. These are usually addressed, in the author’s experience, either by giving the private sector partner substantial operational control (and thus primary responsibility for service delivery), subject to the need for minority (i.e. public sector) approval of certain decisions or, where the public sector partner substantially shares strategic and operational control in the IPPP, by establishing a strict division between staff responsible for delivering the service (and normally employed by the IPPP) and those responsible for contract management.

<sup>51</sup> See *Increasing Competition and Improving Long-Term Capacity Planning in the Government Market Place*, OGC, December 2003 (hereafter referred to as the Kelly Markets Initiative).

<sup>52</sup> This is discussed further in Chapter 5 below. There must also, of course, be a project which is affordable over its life, brings clear economic and/or financial benefits, is sustainable in technical and environmental terms and does not involve unacceptable risks to the public sector.

## **Allocation of risks**

From the description of the commercial logic of PPP (see above, p. 11), it is clear that it normally makes sense for the public sector to allocate the construction risk to the private partner (the risk that the asset will not be constructed on time and to budget) and the availability risk (i.e. not being entitled to payment until and unless the asset is available for use).

The judgement as regards the transfer of the demand risk (i.e. the risk that there will be variation in the demand for the service) is often more difficult. For example in PPP for the management of prisons, particularly where custodial services are included in the contract, the private sector cannot control and therefore cannot manage the number of prisoners given custodial sentences. If the private sector were to be asked to accept this risk, it would probably do so only on terms which would not represent value for money for the public sector. So in the case of PPP for the management of prisons the risk transferred to the private sector is the so-called “availability risk” i.e. they are required to maintain an agreed number of prison places in a state fit for the delivery of the service and are paid on the basis of the availability of those places whether or not they are used.

There have also been several well documented cases in which the demand for free standing transport PPP has been significantly overstated, thus threatening the viability of the scheme, such as the M1-M15 motorway project in Hungary and the Channel Tunnel Rail Link in UK.

The private sector will also normally bear the financing risk re the cost of finance, which may in some cases include an exchange rate risk and the operating cost risk (i.e. the control of operating and maintenance costs).

There are some risks which in practice always have to be borne by the public sector, such as the risk that the project will fail to gain public support (the so-called “public acceptance risk”), the legislative and regulatory risks i.e. that the public sector will change its mind or change the law or administrative practice in a manner specific to the project (as opposed to general changes in the law) and the affordability risk i.e. that the Contracting Authority finds difficulty paying the periodic charge. One recent example of a specific change directly impacting on PPP hospital schemes was the recent introduction of patient choice in the UK health sector which, combined with a financing regime based on patient flow, has the potential to undermine the income stream to hospitals used to pay the PPP periodic charge. There are others which are generally best borne by the public sector, such as the need to secure title to land on which the assets are to be constructed and the necessary planning and licensing consents and the environmental impact of the project.



The demand risk can in some cases be shared between the public and private partners e.g. the financial impact of variation in traffic flows can be set at maximum and minimum levels as can the risk of latent defects, such as unexpected geological conditions encountered in the construction of the asset (often dependent on whether or not the defect was foreseeable by either party).

### **The need for active management of a PPP programme**

Given the current and likely future importance of PPP for the development of infrastructure in the EU, and the scale of the investment needed, there is a need at European and national level to manage PPP in the context of an overall public investment programme and to bring individual schemes to market in a planned way.

This calls for both effective planning of the programme and the existence of an appropriate review mechanism.

The planning element involves a structured process of:

- Creating the right type of organisation to manage a PPP programme i.e. responsible unit with right structure, remit, resources and skills
- Developing and prioritising an investment programme
- Identifying projects in the programme suitable for PPP
- Assessing the market for each sector within which PPP will be used (both the service provider market and the lender market)
- Assessing the public authority's own capacity to commission PPP effectively and manage the resultant transaction so that value for money procured during the award process is delivered in the contract execution phase (e.g. resources available to devote the necessary time to conduct the PPP procurement in such a way as to maximise the likelihood that value for money will be obtained)
- Planning the optimal timing of the investment, taking account of the extent of need for the project, the state of the market and the capacity of the public authority to commission it (and manage its execution) effectively.<sup>53</sup>

As regards the review element, because of the high level of activity in PPP, Member States need a mechanism to allow themselves to step back from individual projects and look at the medium and long term effect of PPP on public service delivery. Since there are relatively few examples so far of PPP schemes which have completed all of their design, construction and operational phases, continuing interim assessment is needed about the out-

comes of using PPP in different services. This is discussed further below in Chapter 2.

The review mechanisms used will almost certainly be different in different Member States. But it is hard to argue that such a review process should not be being undertaken by some entity in each Member State and at an EU level.

### **The need to attract and maintain the interest of the private sector**

This includes both service providers and lenders because there will be no transaction unless:

- The private sector partner can make a profit commensurate to the risks it is assuming<sup>54</sup>
- Lenders are willing to lend to the private sector partner to the extent that the transaction is privately financed.

But this needs to be done in a way which retains the primacy of the public sector’s objective of obtaining value for money in the delivery of public services. The current market model is unduly unfavourable to the public sector in several ways. These include the involvement of lenders only at a very late stage of the transaction (i.e. when the preferred bidder/winning tenderer has been identified), the length of contracts (which makes it difficult to subject the arrangement to periodic competitive pressure, the cost of changing contract terms in a single tender environment and the termination arrangements to compensate lenders where there is failure by the service provider.

The engagement of private partners in PPP should represent stable long-term commitments to the delivery of public services over the whole life of the contract by them. Private financing of PPP should not be regarded as short-term tradable financial instruments, and, insofar as they are by some service providers and lenders, the public sector should consider whether such partners are suitable for engagement in PPP.

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<sup>53</sup> Some practitioners argue that, for service providers and lenders to be interested *at all* in PPP, there needs to be a critical mass of transactions i.e. the so-called “deal flow” approach. The logic of this is hard to accept from a public sector perspective, though there was in the past clearly a need to explain the logic of such transactions to the market. It clearly places the public sector at a disadvantage in that it cannot bring schemes to market at the timing of its own choosing. It also does not put to the test the lenders need to find a profitable home for their deposits nor accord with the significant increase in profit margins which PPP has delivered to the construction sector, thus creating a significant attraction for them to this market.

## The importance of independent scrutiny of PPP

There is a relative lack of publicly available information about the outcome of PPP procurements and the delivered results, especially as few PPP have gone the full course of their life. External auditors have the powers, the independence and in many cases the skills to review both the procurement process and the realisation of value for money in the delivery phase.

Their ability to act as the citizens' watchdog in PPP, and provide assurance of value for money over time is particularly important but is currently under-recognised and under-developed. This is explained in further detail below in Chapter 6.

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<sup>54</sup> Service providers will generally go through an internal process of qualifying a potential project in terms of whether or not it is a potentially attractive for them to bid. The criteria which they will use in the process could include considerations of political and senior officials' commitment at the customer, certainty of legal and regulatory regime, ability of customer sustainably to pay for the services if delivered, likelihood of winning (including track record in the sector), acceptability of the risk profile in relation to the returns expected (including contract terms and conditions), ability to deliver core requirements, prior and current relationships with customer, capacity to bid for and deliver the contract, customer competence (e.g. clarity and realism of objectives and timetable) and importance of the customer to the supplier (contract value *per se*, the reference value of contract).

There are other matters which, in the author's experience, service providers regard as relevant to determining whether or not they choose to bid for contracts. These include matters such as clarity of objectives of the public authority, the need to adhere to procurement timetables set, the importance, as far as possible, of shortening the procurement timetable, the involvement of end users in the procurement process, the importance of access to information about the service (particularly when they are bidding against an incumbent) and an early opportunity to explore possible means of meeting the Contracting Authority's needs. As noted elsewhere, this need not necessarily conflict with what the Contracting Authority would want to do in order to achieve its objectives.

## CHAPTER 2

# Managing a National PPP Programme

### OVERVIEW

PPP are a means for public entities to achieve their policy objectives i.e. they are one means of delivering public services and must be integrated into a wider programme of public investment implemented to deliver those services. Each individual PPP must fulfil an end compatible with policy objectives.

Given the current and likely future importance of PPP for the development of infrastructure in the EU, and the scale of the investment needed, there is a need at European and national level to manage PPP in the context of an overall public investment programme and to bring individual schemes to market in a planned way.<sup>55</sup> Without such planning there may or may not be many PPP schemes, but it is a central contention of this book that this will not address the matter of whether or not they are the most suitable schemes and will represent value for money for the public sector over their life. And

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<sup>55</sup> The author does not here intend to enter the debate about how the policy objectives emerge or the investment programmes are prioritised. This could be in a centralised or decentralised manner according to the different political structures of different states. The key point is that, once the priorities in terms of projects have been determined, the need for efficient capacity and market management should determine the means by which the opportunities are brought to market and the timing of award processes. The author is aware that some may object to the underlying assumption here on grounds of subsidiarity, local autonomy etc., but those who advance these arguments are under an obligation to demonstrate how the unequal bargaining situation of small municipalities, or even individual government departments, as compared to multi-national service providers can be addressed in the interests of value for money. In this sense there may be a conflict of policy objectives between decentralisation and marketisation of the delivery of services, particularly in countries where there are a large number of small municipalities. The objectors may also include some politicians – thinking about the next election – who may not want to be interested in high level and longer term planning. However, whole life value for money includes consideration of the interests of those who will pay for and using the services over the life of the contracts.

PPP are too important to the delivery of infrastructure and public services across the EU to risk *not* managing them effectively.<sup>56</sup> PPP schemes are often controversial and politically high profile. It also stems from the fact that the public sector has finite resources – money and management time and thus must use its resources effectively and judiciously, focusing on projects where there can be success.

The need for effective national and European management of PPP also stems from the fundamental inequality of the positions of the two parties i.e. the public and private sectors.<sup>57</sup> As noted above, the private sector, by reason of frequency of engagement with PPP transactions, has far more experience of such transactions than the public sector and thus potentially a greater ability to negotiate more effectively. But it is also not subject to same degree of scrutiny and democratic accountability as is the public sector, which also has the obligation to conduct their procurements in a transparent way. In short, for all the valid reasons underpinning the Public Procurement Directives, the public sector has to make known its buying intentions, but the private sector does not have to make known its future bidding intentions.

This chapter addresses four key elements of the management of a national PPP programme i.e. the organisation structure needed, the approach to planning a national PPP programme, management of markets in the sectors where PPP are used and the approach to review of PPP implementation. It then addresses the need for co-ordination at a European level.

In doing so, it highlights the key factors which will go a long way towards success in the implementation of PPP i.e. clear political priorities,

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<sup>56</sup> The case for effective management of national PPP programmes to achieve value for money has been made very clearly in the recent UK Office of Government Commerce (OGC) report on the UK construction sector – see below, note 73. Though this deals only with one sector, many of what it calls the “pre-construction factors” leading to increased costs for the public sector have a wider relevance. This report refers (at p. 7) to matters which act as major constraints on supply, or as impacts on supply-side behaviours in the industry which have consequences for the level and nature of responsiveness to public sector demand. These include management imposed constraints due to high bidding costs (“cherry-picking” the most attractive opportunities, no-bidding the others), planning uncertainty and long lead times in responding to major public sector investment plans, uncertainty about future demand profile because of lack of forward planning information for public programmes and major projects, inefficient procurement strategies/routes and their risk-reward trade-offs, lack of design/specification clarity upfront, carrying risk of significant post-contract design changes which impact on cost and on lead times and the capacity and capability within client organisations. Many of these factors could be effectively addressed by a strong central PPP unit.

<sup>57</sup> This is in contrast to the situation when private companies enter into partnerships with private sector service providers, where it is the customer which is often the economically stronger party.

effective central co-ordination, up to date market knowledge, effective market management, the application of effective programme and project management and effective review mechanisms.<sup>58</sup>

## **ORGANISATION<sup>59</sup>**

The effective management of a PPP programme calls for the establishment of a dedicated unit with responsibility for the task and many countries have followed this route.

Because of the potential financial implications of PPP, and in particular the need to manage fiscal risk, it is almost inevitable that this unit should fall within the responsibility of the Finance Ministry,<sup>60</sup> as it does, for example, in the UK, Italy and Ireland, which are amongst the countries with a relatively high level of PPP activity.

This does not preclude the creation, again to use Ireland as an example, of departmental PPP units, which can act as expertise centres within government departments for the realisation of schemes once programmed and may have a significant role to play in market assessment. But these should not have the same remit as the central PPP unit, and should explicitly be recognised to have a role to implement the programme management activity of the central unit.

Secondly, it is important that the central PPP unit should have an unequivocal public sector remit i.e. its *raison d’etre* should be to deliver value

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<sup>58</sup> None of what is suggested in this chapter is, of course, intended to prevent projects proceeding *per se* or to slow down an investment programme. But, by introducing effective management and co-ordination, and a need for rigorous prioritisation and assessment into investment decisions, it may mean that certain projects which might have proceeded either at a time which is sub-optimal or which are not appropriate (e.g. because of cost, suitability for PPP, inadequately specification or inability to attract competition) would not proceed.

<sup>59</sup> This section is not intended to be a detailed text on institution building and resource planning, which clearly needs to be done on a case by case basis. It aims to set out the principles which should underpin the establishment of a central PPP unit based on its defined role.

<sup>60</sup> There remains the question, of course, of who, if the central PPP unit is within the Finance Ministry, should provide independent prioritisation advice, assessment and review of major PPP schemes by the Finance Ministry itself i.e. who guards the guardians? In a UK context this is far from being a theoretical question, given the well-publicised difficulties associated with the introduction of the Child Tax Credit system in 2003. One alternative model would be to locate the central PPP unit in an entirely independent Public Procurement Office, independent, that is, of all government departments and reporting directly to Parliament.

for money for the public sector.

In undertaking market assessment and managing markets, this will, of course, mean engaging with the service provider and lender communities to understand their perspectives. In doing so it should never forget that there cannot be a PPP without a private partner, that there will not be a private partner without the opportunity to make a profit and that there are some risks which the private sector cannot price and thus will not accept, or will accept only at a price which does not represent value for money for the public sector. It will sometimes be the role of the central PPP unit to give this message to colleagues within its own administration. Equally, it will sometimes be its role to explain the public sector's own "deal breakers" to service providers and lenders and to manage supplier expectations. There is thus an element of brokering in its role but one which is always driven by the desire to obtain value for money for the public sector, which, may, in some cases, mean a project not proceeding or being deferred if it is not in the public sector's interests for it to proceed.

Thirdly, it is important that the central PPP unit should not be responsible for *promoting* PPP and should have an explicit position that:

- PPP are sometimes but not always the right means for achieving value for money in public service delivery
- The test of when PPP should be used should be pragmatic not ideological (i.e. that PPP should not be the default option for a public investment project but properly assessed on a case by case basis).

The role of the unit should be to ensure that PPP *are implemented effectively when it is assessed as the most appropriate means of doing so*, including in its timing. This includes removing legal, administrative and operational barriers to the use of PPP so that it becomes a viable option for public service delivery.

Without such an explicit frame of reference there could be a risk that the central unit will act to promote PPP.

This will be particularly true if the unit has performance measures which relate to the volume of schemes implemented. It will then face difficulties being objective in the discharge of several of its functions outlined below, including those of programme co-ordination (especially when advising on the timing of schemes), project clearance i.e. approval of schemes to be financed by a PPP), and when reviewing the implementation of projects and programmes.

Fourthly, it should be free from any possible conflict of interest in three senses i.e. that:

- It should be funded as an overhead from the state budget and not be

required to finance itself from advisory work, even if this advisory work is confined to other public sector bodies.<sup>61</sup>

The need to earn income from advisory work can lead to the danger that the unit will promote a particular PPP, or PPP in general, in order to achieve financial targets. It would also be difficult for a unit to be dependent on income from other public sector entities as clients on the one hand, and on the other act in the regulatory and supervisory role which is described below

- Central PPP units frequently benefit in their role from the skills of seconded advisers from the private sector. This can be beneficial in providing a diversity of approach and a rotating pool of talent as well as in the discharge of its role of market assessment and market management but it needs to be managed carefully. They will almost inevitably come from organisations which have a commercial interest in promoting PPP because they wish to be engaged in it as suppliers, lenders or as professional advisers. The risk to be managed here is to ensure that, if and when seconded staff are engaged to undertake assignments, they are briefed to do so in a way (and effectively controlled in the delivery of outputs) which is not influenced by their commercial interest in the implementation of PPP.

It is not likely that seconded staff will be placed in a position of direct conflict of interest, such as reviewing a PPP scheme where their employer acted as adviser to the public entity in a transaction. The difficulties which could arise are more likely to be related to ensuring that any work done, and particularly policy advice, by a seconded member of staff clearly follows the explicit mission of the unit in not acting to promote PPP<sup>62</sup>

- As regards the specific elements of the remit of the unit set out below, it would clearly be desirable if there were an internal separation of duties as between the review function and the other functions, and particularly programme management and project clearance.

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<sup>61</sup> This is not meant to be an argument for or against a fee earning public sector advisory unit, as for example, Partnerships UK and the Czech PPP Centrum are, but that a central regulatory and supervisory body should not include a fee earning remit.

<sup>62</sup> There have for example been some recent reports by international professional services firms which could be interpreted (and, in the author’s experience, not entirely unreasonably) as seeking to promote the idea that there are some refinements to PPP which would make them even more complex than they already currently are (e.g. with very flexible/less well defined initial outputs) and creating the impression that public authorities cannot handle PPP without the extensive support of the firms concerned. Such well written marketing tools are examples of what a PPP unit should avoid.



As regards the remit of the central unit, this should include:

- Programme co-ordination, undertaking the planning and market management and review functions at national level set out in the following three sections
- Project clearance, i.e. initial approval, amendment or rejection of PPP schemes to proceed in the format, and at the timing, proposed by a Contracting Authority and the subsequent confirmation at each stage of the process of approval to proceed<sup>63</sup>
- Training of public officials in good practice in procuring and managing PPP, thus creating capacity in this field
- Promotion of good practice and knowledge sharing between Contracting Authorities<sup>64</sup> and between the central PPP unit and third parties, including, for example, other national PPP units, and, where appropriate, the service provider and lender communities
- Programme and project review, as set out below,<sup>65</sup> aimed at ensuring that the lessons learned are captured and that, most importantly, procured value for money is converted into delivered value for money in the project execution phase<sup>66</sup>
- Advice to central government on removal of legislative, administrative and operational barriers.

This is a wide and demanding remit, but one which gives it the necessary authority to manage a national PPP programme. In effect it means that

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<sup>63</sup> This would be in a form similar to the OGC's Gateway™ review procedure, which involves independent review of the continuing desirability of proceeding with the project at certain key points (including business justification, procurement strategy, the point of investment decision and readiness for service) and has become widely recognised as being good practice. It is done by experienced professionals who are independent of project team. The review is intended to be confidential, robust and minimise the risk of over-optimism caused by emotional attachment of those too close to the process as well as an objective basis for assessing the impact of changed circumstances on a project in procurement. But it is clearly possible to envisage circumstances where, rightly or wrongly it could also be used to provide political "cover" for a policy change where the initial commitment was hasty or inappropriate.

<sup>64</sup> This could include creation of standard documentation for PPP contracts, the development of a defined range of PPP models, showcasing good practice and technical guidance addressing key contract strategy issues.

<sup>65</sup> Again, this could incorporate the benefits evaluation element of the OGC's Gateway™ review procedure.

<sup>66</sup> The balance between the programme co-ordination/project clearance elements and the project review element of the role is an important judgment for the central unit. It mirrors the importance which individual Contracting Authorities also have to balance between the planning, procurement and contract management elements.

PPP schemes proceed to the timetable managed by the national PPP unit and only come to market when they have been approved by the central PPP unit.

None of this can, of course, be done without the appropriate level of resources and skills.

As regards the skills needed, this is likely to include, at least, a mix of project management, financial, commercial, legal, operational and human resources skills (the latter because some PPP will include staff transfers from the public to the private sector) and reflecting the multi-disciplinary nature of PPP. It is also likely to require leadership from senior officials who are already experienced in PPP and who are committed to effective implementation of PPP over time. It is emphatically not a role which will be discharged successfully by a reluctant official or one viewing it as a short term post as part of a rotation.

The resources needed will vary according to the ambition of the administration to implement PPP and the resourcing of such a unit needs to be based on a detailed assessment of roles and responsibilities. But two observations can be made, based on the author’s experience of institution building and in the design of contract management capability.

Firstly, it is clear that the central PPP unit will be a significant stakeholder in the PPP market in each state, influencing degree of success of the programme. So, in undertaking such an assessment it would therefore be counter-productive, given the amounts of money involved in PPP, to under-resource the PPP unit such that it could not effectively discharge its role.

Secondly, since this unit has a policy role it would not be appropriate for it to rely on seconded or temporary staff. Thus, contrary to the practice in some operational services, it would not be appropriate for such a unit to be resourced to a minimum level of expected demand supplemented at peaks.

This is because, in the nature of the work to be undertaken, even if peaks occurred<sup>67</sup> and could be forecast, it would not necessarily be possible to recruit suitable staff to cover those peaks i.e. with the appropriate skill levels and free from conflicts of interest. In any event, the nature of the remit, which includes training and promotion of knowledge sharing, should allow for useful activity to be undertaken even if temporary work troughs are anticipated in the core programme management, planning and review tasks.

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<sup>67</sup> Bearing in mind the emphasis placed in PPP on public sector capacity planning.

## PROGRAMME AND PROJECT PLANNING

The planning element involves a structured process of:

- Developing and prioritising a multi-annual investment programme for major investments across government and sub-national authorities.<sup>68, 69</sup> This calls for a process of bid by other public authorities to the central unit and an assessment, approval and resource allocation by the central unit.<sup>70</sup> The importance of prioritising an investment programme remains true even for financially free-standing PPP, since the viability of such schemes may depend on associated projects (e.g. feeder roads, new bridges etc.) which require contribution from the state budget and thus require prioritisation<sup>71</sup>
- Identifying projects in the programme potentially suitable for PPP, based on a case by case assessment<sup>72</sup> and a clear idea of how these will be financed i.e. the balance between national public finance, EU financial support and private finance
- Assessing the market for each sector within which PPP will be used (described further below).<sup>73</sup> This may lead to an adjustment to the list of projects potentially suitable for PPP<sup>74</sup>
- Assessing the public authority's own capacity to commission PPP effectively and manage the resultant transaction so that value for money procured during the award process is delivered in the contract execution phase (e.g. resources are available to devote the necessary time to conduct the PPP procurement in such a way as to maximise the likelihood that value for money will be obtained). Again, this may lead to an adjustment to the list of projects potentially suitable for PPP<sup>75</sup>
- Planning the optimal timing of the investment, taking account of the extent of need for the project, the state of the market and the capacity of the public authority to commission it (and manage its execution) effectively. This leads to an approved investment schedule for major investments, without which there is no authority to proceed
- Pre-launch reconfirmation of project suitability for PPP. At this point the Contracting Authority has the clearance to proceed with the award

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<sup>68</sup> Clearly, it would not be appropriate or an efficient use of time, for a central unit to manage all investment projects. The level below which it does not is a matter for judgement from state to state. In the UK, individual investment schemes have been deemed not to be suitable for PPP if they have a value of less than £20 million (about €30 million at the time of writing). If an administration does not wish to adopt this approach for PPP projects in all sectors, it could be applied only to certain key sectors and remains valid, though it may lose some of its market management effect if it is only partially applied e.g. if certain key ministries are exempt from its application.

process

- Deliver agreed aims through project procurement, with the central unit’s role being to manage the project clearance process set out above.

## **MARKET MANAGEMENT**

It is a central contention of this book that PPP markets have to be actively managed by the public sector or they risk losing control to the private sector. Hence market management competence is a key responsibility for a central PPP unit and a key skill needed.<sup>76</sup>

The key issue here is not solely connected with state ownership of providers, though this can in some case distort competition when they operate outside the geographical or sectoral area within which they have been granted a monopoly. The key idea is that no market should be dominated by the public or private sectors and that good value for money is achieved by maintaining tension between them.<sup>77</sup>

The market management element of the central unit’s role has several key elements:

Firstly, knowing what is currently happening in the market. This means having:

- An up to date knowledge of supply markets. This includes matters such

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<sup>69</sup> In the PPP Green Paper the Commission raised the question about so called “private initiative PPP” and how non-national operators could be guaranteed equal access to them, though the same issues are valid for operators other than the promoter but in the same state. Private initiative PPP are virtually unknown in some EU Member States, such as the UK and Germany, but have fostered much PPP activity in Italy. This allows private promoters to propose projects to public authorities, who have the choice whether or not to adopt them in their investment programme, but then still have to subject them to the normal award procedures under the Public Procurement Directives. The Commission then referred to various methods by which private initiative PPP are being encouraged by giving some sort of advantage for first movers. The concept of private initiative PPP is entirely contrary to idea that investment programmes, let alone those delivered by PPP, should be initiated and managed by a national government. If there is doubt about the capability of a national or regional government to determine its investment priorities, then the solution is better investment planning and not allowing the programme to be driven by suppliers. It is also difficult to see how in practice advantage for first movers can be given in a way which is consistent with the principles of equality of treatment and non-discrimination – the tests being how much competition there is in private initiative PPP and how often the contract is won by a supplier other than the first mover.

<sup>70</sup> For a comprehensive framework for developing business cases the reader is referred to the “Introduction to Procurement” section of the OGC’s web site ([www.ogc.gov.uk](http://www.ogc.gov.uk)).

<sup>71</sup> Even if this were not the case, the finite resources of management time available to manage projects in a public authority means that there is a need for prioritisation.

as what is driving the market (e.g. EU or domestically driven investment need), market size, market share of different providers, the balance between public sector and private sector provision, who might be future potential market entrants or who might be about to exit the market, the amount of current delivery capacity in the market (taking into account current contracts being delivered by providers and their ability to absorb more), profitability, tendency to form consortia and its impact on competition, extent of commitment to market of suppliers and lenders, whether there might be market consolidation through takeover or merger, whether or not there are secondary markets developing in PPP stakes in that sector etc.<sup>78</sup>

- An up to date knowledge of demand by other public bodies, which will impact on the interest of suppliers in a given PPP, demand which can be viewed at a national or European level according to the nature of the market<sup>79,80</sup>
- An up to date knowledge of financial markets. This includes the availability of private finance for PPP schemes, such as the willingness of equity investors to invest and the appetite of lenders to lend, and their attitude to risks in emerging markets, the terms on which they are willing to lend, the attractiveness of different funding options, the development of new financial instruments to spread risk etc. This will inform an assessment of funds available from all sources, i.e. in addition to private lending, sources such as EU Structural Funds, the state budget and, in some cases, user charges. It can also include monitoring of developments in secondary markets such as the level of interest in infrastructure assets, the activities of infrastructure investment funds and an assessment of the potential of the project for refinancing.

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<sup>72</sup> In respect of an individual project this means in effect asking:

- Is this a project which should be done at all?
- If so, how much of a priority is it?
- Should it be done by PPP?

<sup>73</sup> A recent example of such a market assessment can be found in a report commissioned by the UK OGC on the future of the UK construction industry See *2005-2015 Construction Demand/Capacity Study*, OGC, June 2006.

<sup>74</sup> It is a given that this part of the role is particularly important in the early stages of a national PPP programme, where a decision will need to be made about where to start the programme to maximise the likelihood that early schemes will be successful, thus ensuring that PPP remains a viable option for public service delivery. The consequences of not doing so were felt very acutely in the Czech Republic where the cancellation of the D47 motorway project in 2003 has continued to influence the public perception of PPP as a concept. In general terms it would be wise for pilot projects to focus on projects which are scaleable (i.e. not too large) and in sectors where the contracting model is well established, thus ensuring that service providers and lenders understand the risks well.

Secondly, to act where appropriate as market makers i.e. by engaging with the market outside the scope of specific opportunities to understand the market’s perspective on key issues (and in particular the attitude of service providers and lenders to particular project risks), to share with the market the public sector’s perspective on emerging issues and to make known future opportunities.

If such market consultation is done in a way which self-evidently does not favour individual suppliers and is open to new participants, as it must be, this can often encourage suppliers to consider preparing for entry into new markets and to prepare to bid for specific opportunities. The promotion of competitive supply markets has several benefits which impact at different points in the PPP process, including in the initial award, replacement of non-performing suppliers by the Contracting Authority and the exercise of step-in rights by lenders

Thirdly, using market intelligence to:

- Bring opportunities to market at a time when they are likely to attract sufficient competition so as to maximise the likelihood of securing value for money.

What constitutes sufficient competition is a matter of both law and of commercial judgment. The Public Procurement Directives – see Art

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<sup>75</sup> It is thus clear that there are two aspects to absorption capacity. Firstly, the ability of the public sector to plan, procure and manage PPP where they wish to use them. Secondly, the capability of the private sector to bid for the opportunities which are available *and their willingness to do so*.

The skills needed, and tasks to be undertaken, by the public sector are set out in further detail below in Chapter 5, which makes it clear that PPP are time consuming. The key issue here is for an appropriate resource assessment to be made at the time of programme planning, balancing internal resources and external consultancy (which itself of course needs to be managed from both a competence and freedom from conflict of interest perspective). In the UK, the Kelly Markets Initiative (see above, note 51) attempts to address supplier capacity planning by defining future government commitments and make the knowledge available to suppliers. This does not mean of course that absorption capacity is managed at sub-national level, nor does it ensure that bidders will actually bid for opportunities. It thus may be helpful if the central PPP unit could get some sort of assurance (whose delivery could possibly form part of an assessment of the reliability of bidders under the terms of Art 48(5), Directive 2004/18) that bidders will actually bid to supply future government needs as a *quid pro quo* for forward planning information. Furthermore, in any process of assessing the absorption capacity of a supplier, the central unit will want to take account of how quickly candidates for short listing can expand their businesses.

<sup>76</sup> The importance of effective and coordinated use of public sector buying power was highlighted in a UK context by a report of the Office of Fair Trading (OFT), *Assessing the impact of public sector procurement on competition (summary)*, OFT 742(a), September 2004, p. 4.

44(3) of Directive 2004/18 – say that the number of candidates invited to tender, negotiate or conduct a dialogue in a contract awarded respectively by the restricted procedure, negotiated procedure with the publication of a contract notice and for competitive dialogue must be sufficient to ensure genuine competition. The minimum number is set at five for the restricted procedure and three in the other two cases, though a Contracting Authority may continue with the procedure with lesser numbers if there are not enough candidates who do meet the minimum selection criteria. This is only part of the picture i.e. what matters from the point of view of the Contracting Authority is that the selected short list will actually submit offers and thus create the necessary competitive tension, though this cannot always be predicted with certainty. Superficially it may seem that the way to ensure sufficient offers is to invite more than the minimum number required by law. But, given the bidding costs involved in a major transaction such as a PPP, to have too many on the short list may create the impression amongst serious bidders that there is an element of lottery in the award process and may thus actually discourage bids. This is not an easy judgment to make but it can certainly be informed by up to date market understanding

- Structure transactions in such a way as to maximise whole life value for money, in which key considerations will include<sup>81</sup>:
  - The financing structure e.g. the public-private finance balance, the debt-equity balance and different kinds of debt
  - The length of the contract to be awarded<sup>82</sup>
  - Whether or not 100% of the contract will be awarded to the same provider

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<sup>77</sup> Though related to conventionally procured services rather than PPP, the UK audit market for sub-national audit is a good example of how this can work in practice. This is regulated by the Audit Commission which sets the standards for audits and determines the specifications. It allocates a majority – currently about 65% – of the total value of audit work to its provider arm, which is set up as a profit centre, and the remainder to several private sector audit firms. But these percentages are not fixed for all time and all parties are incentivised to continue to deliver what the Audit Commission requires by the nature of the competition in the market and the prospect of winning or losing market share. It is a model which merits reflection for other sectors.

<sup>78</sup> At the time of writing (mid 2007) there is evidence that investors find infrastructure companies an attractive investment because of the long term and relatively secure cash flows which they can generate. Airports and water companies have, for example, attracted strong interest.

<sup>79</sup> According to a recent survey by PricewaterhouseCoopers, 85% of all current PPP activity is in Europe, though clearly there may be a point where non-European opportunities become a factor to be seriously considered in market assessment. See *Developing Public Private Partnerships in New Europe*, May 2004, p. 13.

- The scope of the services provided<sup>83</sup>
- The extent to which the availability and demand risks will be transferred to the private partner
- The extent to which payments will be performance related and the maximum level of deductions which could be made from the periodic payment penalty
- Key contract clauses such as warranties, indemnities, insurance, indirect losses, gain sharing on refinancing, asset disposals and third party income
- Minimise the risk of undesirable influences on the transaction i.e. preventing “encirclement” of a Contracting Authority about to offer an opportunity to market i.e. that, before the award process is launched, potential bidders making informal contact with decision makers and, in some cases, influencing decision makers indirectly through third party influencers. This not only raises questions about the probity of the process but also can have a serious impact on competition. If some market players know that this encirclement has happened, they may conclude that the selection decision has in effect been made outside of the formal process and may thus either not bid or submit what the author one described as an “elegant no-bid” i.e. an expression of interest which was well below the true capability of the organisation making it, and concentrate their efforts elsewhere

Fourthly, understanding the relative balance of power between the public and private sectors in the market.

This will be related to the availability of other opportunities in the market and whether or not the “tipping point”<sup>84</sup> has been passed. The idea of the

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<sup>80</sup> Some elements of private sector demand will also be relevant to the market assessment as was highlighted by a recent UK market capacity study in the ICT sector in the UK (see *Chief Information Officers’ Council Information, Communication and Technology Market Capacity Pilot Project Report*, OGC, July 2006. More generally, this report serves to highlight the fact that the public authority should regard itself as being in a competitive situation when procuring a PPP i.e. wanting to attract enough service providers (who have a choice of opportunities) and lenders willing to lend on competitive terms.

It also highlights that service providers actively qualify opportunities, thus making it important for the public sector to be aware of what service providers regard as important. In any major procurement there is a complex judgment to be made by the Contracting Authority in determining which of the issues raised by the service providers it can accommodate in its programme and project planning and contract award procedures without putting at risk its core objective of achieving value for money in public service delivery.

<sup>81</sup> See below, p. 116 et seq, for a fuller description of the elements of a contract strategy.



“tipping point” is that, at a certain point, there is a decisive shift in a situation not necessarily caused by a single large happening but a small happening which, in combination with previous events, causes a shift in the balance of power. It is not, of course, a concept confined to analysis of markets. In the care homes example cited above (see p. 18) the tipping point had already occurred i.e. the balance of power was decisively with the private sector, and had happened almost without the intention that it should happen and shows that when it has passed, it is difficult for the public sector to reverse, though the UK government did take the company responsible for maintenance of the railway infrastructure (Network Rail) back into public ownership in 2001 when it was patently in financial difficulties and not achieving performance targets. This kind of action does however have a price if exercised too frequently or in less clear cut circumstances i.e. the legitimate expectation of the private sector that contracts will be honoured. The conclusion is that it is better to avoid the shift in the balance of power occurring in the first place. In the context of PPP it is the point where the extent of use of partnership with the private sector in a particular service impacts on the future choices for public service delivery in a service or sector.

Fifthly, retaining an exit strategy. This means being in a position to:

- Choose, either before, during or after an award process, **not** to enter into a PPP transaction with any provider because it does not represent value for money i.e. decline to sign a bad deal while still maintaining service delivery
- Be able to exit without undue cost<sup>85</sup> or service disruption from a transaction where the private sector partner is failing to meet the expectations of the partnership i.e. to suspend or terminate the contract or change suppliers.<sup>86</sup> This could be operational or financial failure, and in some

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<sup>82</sup> In *the PPP Green Paper* (at p. 15) the Commission raised the question about whether or not the length of a PPP contract could infringe the principles of the Internal Market and the competition principles of the EC treaty (Art 81, 82 and 86(2)). The Commission’s view is that the duration of the contract should not “limit open competition beyond what is required to ensure that the investment is paid off and there is a reasonable return on invested capital”. A Contracting Authority will be concerned to set the optimum contract length, having regard to factors such as the likelihood of future change in service need arising from economic, social, political and technological reasons, possible variations in the cost of service over different contract periods, the time needed for the service provider to effect improvements in service delivery, the useful life of the assets which are the subject of the PPP and length of time for which loan finance is available.

<sup>83</sup> In the context of a health sector PPP, for example, this could include clinical services, property maintenance services (so called “hard facilities management services”) and other services such as security, cleaning, laundry and catering (so called “soft facilities management services”).

cases may be related to business of the service provider other than the partnership<sup>87</sup>

- Resist the pressures of private sector in the execution of the contract to make changes which are unfavourable to the public sector or to be unable to make changes reflecting new legislative requirements
- Exit in a planned way at the end of a contract either by transfer of the contract to another provider or decommissioning an asset and not *de facto* be obliged to re-contract with the existing partner.

The need to retain an exit strategy is often overlooked by public authorities, perhaps understandably in the light of the emotional commitment associated with the establishment of a PPP. No public authority wants to enter into a PPP with the expectation that it will need to be terminated prematurely. But if the private sector partner fails, a public authority should ensure that it has the right to suspend or terminate the contract, can exercise that right because it can afford to do so and have the ability to recover transitional costs from the provider. Without an exit strategy, a public authority will get locked in to a transaction, and, if it does, it will find it difficult to get value for money.

Two key elements of the test of the ability to exit from a transaction without undue disruption are ensuring that there are alternative sources of private sector supply and, as importantly, to maintain public sector service delivery capacity, both of whom could step in if necessary to deliver services.

In the context of PPP, there are a number of ways in which this might be achieved. It could be done in a specific market by ensuring that there is a mix of service provision between the public sector (either directly or through IPPP)<sup>88</sup> and the private sector through contractual PPP i.e. to determine that

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<sup>84</sup> The tipping point was well explained in January 2006 by James Strachan, the retiring chairman of the UK Audit Commission (which is responsible for overseeing the audit of both local authorities and health bodies in the UK) about the use of public funds to buy elective surgery previously delivered in state owned hospitals from privately owned clinics. This is being done to increase overall treatment capacity, reduce patient waiting times and provide choice for patients. Mr Strachan was reported as saying that “there is little issue when the private sector only makes up 5% of NHS work but when it starts to be 15% or 20% it clearly starts to have implications for the remaining 80%”. He said that outsourcing significant slices of NHS work will have implications for the remaining services and that somebody within the UK health service must take responsibility for checking the bigger picture. This debate on the tipping point is clearly relevant to other services and EU Member States, though the answer will differ from case to case.

<sup>85</sup> This can be significantly affected by contract terms relating to termination liabilities, which are normally insisted upon by lenders.

each of these types of transaction would have a given market share. This would not contravene Art 295 of the EC Treaty, which is neutral as between public and private ownership of property (and hence means of service provision). It would also not contravene the Public Procurement Directives if, in the case of an IPPP, the private partner were selected in accordance with the rules of Directive 2004/18. It would also maintain competitive tension between the public and private sectors which, for example in the UK prison management sector, has been noted to act as a mutual incentive to improve performance<sup>89</sup>

At minimum the ability to exit means having a contractual right to recover physical and information assets and to re-employ the people necessary to deliver the service either temporarily or indefinitely and to have the co-operation of outgoing supplier in a transitional period.

In advancing the argument for a mixed provider market, the author is aware of the objection raised by some that such an approach could lead to the distortion of competition, if state owned providers operate outside their territorial area of origin or core sector or fail to maintain/are not required to maintain ring fenced accounts for its activities in separate markets. This has been an issue, for example, in the energy sector, with the activities of some large state owned providers. But these are issues which can be addressed

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<sup>86</sup> In the PPP Green Paper the Commission raised the question about whether or not *lenders'* step in rights – i.e. their right to replace the private partner without competition in order to rescue the contract – raised questions about transparency and equality of treatment. The conclusion of stakeholders was, perhaps not surprisingly, that they were a very important part of the security of lenders in financing PPP transactions. From the public sector's perspective, the exercise of such step-in rights should require their approval, should be based on objective need i.e. the threat to the quality of service delivery and to the ability of the service provider to meet its debt obligations, should be subject to the requirement that the new service provider meets the minimum selection criteria to have been originally short listed better than any organisation which was not short listed and should not be based on a re-negotiation of the terms of the contract in favour of the supplier. They can have the advantage for the public authority of being a less disruptive way of removing an unsatisfactory service provider than a re-tendering procedure.

<sup>87</sup> The author does not exclude the possibility that public authorities do on occasion manage contracts in such a way as to make it impossible for the service provider to deliver the objectives as a means of generating grounds for terminating a contract. But this is not a sufficient reason for a public authority not to have the right to terminate a contract when this is appropriately justified.

<sup>88</sup> The use of IPPP to deliver services also provides Contracting Authorities as joint venture partners with access to information necessary for cost benchmarking and maintaining value for money throughout the delivery of the contract.

<sup>89</sup> See *International experiences with public-private partnerships in the prison system – An inventory*, Report of the Netherlands PPP Kenniscentrum, p.13.

under Art 82 of the Treaty (relating to the abuse of a dominant position). They are not sufficient reason for not implementing a mixed supply market.

## **PROGRAMME AND PROJECT REVIEW**

As regards the review element, because of the high level of activity, Member States need a mechanism to allow themselves to step back from individual projects and look at the medium and long term effect of PPP on public service delivery. This needs to be an active and embedded part of the role of the central PPP unit but there is little evidence across the EU that it has been done systematically to date.

Since there are relatively few examples so far of PPP schemes which have completed all of their design, construction and operational phases, continuing interim assessment is needed.

Some of the key questions which such a review mechanism might address include:

- Is the public entity trying to pursue PPP on an ideological rather than a strictly value for money basis?
- Is the choice of PPP for projects being assessed on a case by case basis?
- Is the choice of PPP being unduly influenced by past events (e.g. past failed projects which were procured through conventional procurement)?<sup>90</sup>
- Does the choice include consideration of balance between public and private finance?
- How are any short term pressures leading to bias in favour of PPP (e.g. tight budgets/legislative demands) being managed?
- In the decision to use PPP are the market assessment and management tools being applied effectively e.g. to avoid stretching public sector capacity to commission and being aware of the risks of public sector over-dependence on the private sector generally or on individual suppliers’ or on the market’s capacity to deliver, which could reduce competi-

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<sup>90</sup> One project often cited in the UK as being a justification for the use of PPP was the extension to one of the lines of the London Underground – the Jubilee Line – which was delivered two years late and two thirds over budget. For fuller analysis of the issues associated with the Jubilee Line Extension and the validity of its use as an argument for PPP, see *Down the Tube – The Battle for London’s Underground*, Christian Wolmar, Aurum Press, 2002, p. 78 *et seq.* There has often been an inconsistency in these arguments in that they compared projects at different times in the UK i.e. the earlier conventional procurements mainly occurred before significant improvements had been brought about in government procurement through the establishment of OGC in 2000.

tion?

- Is the choice of PPP reviewed during the award process to reconfirm that it remains the right choice (e.g. by a means similar to the OGC Gateway™ procedure)?<sup>91</sup>
- How is the overall impact of PPP on future borrowing capacity being assessed and fiscal risk being managed effectively? i.e. the ability of Contracting Authorities to meet their annual obligations and of states to sustain the level of borrowing in PPP schemes?<sup>92</sup>
- Are PPP delivering expected outcomes? (i.e. agreed standards at agreed price)
- Are there any services in which PPP are working notably better or worse than elsewhere?
- Are PPP consistently delivering better performance in all services?
- How is the overall impact of PPP on future policy choices being assessed?
- Is there a difference between the value for money at the design and construction phase and in the operational phase?
- Is risk transfer truly effective in all services? i.e. can there really be “no bail out”?
- Is the public authority managing the contract in such a way as to ensure that procured value for money becomes delivered value for money?
- Have there been any unexpected events in any market? (e.g. supplier failure, supplier change of ownership, sale of stakes, refinancing, asset sales etc.)<sup>93</sup>
- As PPP markets mature, do suppliers and public entities expect the future to be different from the present and, if so, how?
- Will profit margins be higher or lower in future?

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<sup>91</sup> See above, note 63.

<sup>92</sup> This is not just necessarily a concern of the public sector. Lenders will want to be assured that the public authority is able to meet its financial obligations to the service provider. The central co-ordination of PPP within a territorial unit can also act to provide assurance for lenders that sub-national bodies have the legal powers to enter into a contract and can help to underpin lenders’ assessment of the creditworthiness of sub-national bodies.

<sup>93</sup> There is little evidence the public sector anticipated the impact of the fact that PPP transactions could be re-financed by the investors in an SPV on more favourable terms once the construction phase was completed. This enabled investors in some cases to withdraw cash from the SPV much earlier than expected, thus dramatically increasing their returns. This was made clear in a UK Parliamentary investigation, *The refinancing of the Norfolk and Norwich PFI Hospital*, House of Commons Committee of Public Accounts, Thirty-fifth report of session 2005-2006. Nor is there any evidence that the development of secondary markets in investors’ stakes in PPP was foreseen.

- Will PPP be used for more services, less services or different services in future?
- Is an assessment being made of the level of private sector provision beyond which public entities lose control of the means to effectively regulate service provision?<sup>94</sup>
- Will there be more competition or less competition for individual contracts in future? e.g. because of supplier consolidation (mergers/takeovers) and/or the volume of opportunities available
- Is there an effective exit strategy in place? e.g. does the public entity have the ability to terminate the contract where there is unsatisfactory performance or to change suppliers at the end of a contract?

The answers, and the review mechanisms used to reach them, will almost certainly be different in different Member States – here it is proposed that it be done by a central PPP unit. But it is necessary that such a review process is being undertaken by some entity in each Member State and at an EU level.

## **EUROPEAN PPP CO-ORDINATION**

At a European level, there has been much debate about how PPP can be effectively implemented and the Commission included a question on this subject in the PPP Green Paper.<sup>95</sup> This produced a variety of suggestions from stakeholders, and nearly unanimous support for a collective consideration of PPP issues at EU level. Most of the suggestions argued for different means of exchange of best practice such as establishing a centre of excellence/resources and documentation centre or an observatory with a role to include European-wide dissemination of PPP information, promotion of “scientific assessments” of PPP, coordination of existing national networks, training and certification of PPP mediators and the resolution of potential conflicts between EC and national law on PPP-related issues.

But the arguments which have been advanced above for structured coordination at national level between different parts of the public sector also have force at EU level, particularly but not exclusively for the implementation of cross-border PPP such as many of the TENs projects.

There will be different views, in part based on the debate between efficiency and subsidiarity, about the most appropriate means of achieving that

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<sup>94</sup> This issue is discussed further above, see p. 18.

<sup>95</sup> See *the PPP Green Paper*, Question 22.

co-ordination. But the most persuasive argument for the most prescriptive of these approaches, i.e. a European PPP Executive Agency, is the limited extent to which the TENs projects have so far been implemented.<sup>96</sup>

In addition, the case for such an agency is that:

- Because PPP are long term and often high value transactions, decisions being made now will influence public policy choices and service delivery options in the EU for the long term future
- There is an absence of high level planning for PPP, which an agency could address e.g.
  - There is little evidence of co-ordination in the implementation of PPP at European level and an apparent lack of will to bring about such co-ordination (especially management of the timing of opportunities and the management of markets in particular PPP sectors)
  - European legislators continue to pass laws without any detailed analysis of how the cost of implementing them will be met both at EU and national level. This could undermine the EU's *de jure* neutrality between public and private sector provision and lead *de facto* to the increasing use of privately financed PPP becoming inevitable and an agency could help to provide advice in this respect
  - Much effort is being expended on procuring PPP – some of which could be avoided by better sharing of good practice – but there is far less effort devoted to reviewing whether or not they are delivering value for money and there are real difficulties for third parties (except for auditors) in gathering information about whether or not actual performance and actual costs match what was agreed at the time of the contract. Again, an agency could undertake this role at a European level
  - There is a need for greater legal certainty in the EU legislative framework to ensure that PPP, when used, are procured by the most competitive and transparent means, and an agency could act as an effective means of effecting such a change
- The consequences identified at national level of the absence of such high level planning, including failure to obtain value for money in individual projects (and thus an even larger funding gap) and loss of control of markets by the public sector (leading to the risk of poor value for money and constraint of policy choices) also apply at EU level for cross-border schemes. In short, the greater the need of the public sector for

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<sup>96</sup> It remains to be seen how the recently created TENs agency will impact on this particular policy aspect. This agency, of course, has a narrower remit than a horizontal agency proposed here.

private finance for investment programmes, the greater the power which lies with the private sector – both service providers and lenders. Without proper co-ordination, the public sector’s position could be further weakened

- A corrective is needed to the influence on decisions of the short term thinking of some politicians – thinking about the next election – or officials – thinking about their time in post, whereas PPP are long-term transactions. An agency is needed to act as the inter-generational voice in the EU on matters such as fiscal risk and maintaining public sector control over policy choices.

So there is clearly a role which such an agency could fulfil, if it were given supervisory powers over the scope, objectives, timing and length of certain high value, high profile, long term contracts in some sectors, the authority and capability to advise on the creation of an appropriate legal and regulatory framework for PPP, the remit to review the implementation of PPP across the EU and candidate countries and, possibly, the management of any investment in such projects from EU Structural Funds.<sup>97</sup>

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<sup>97</sup> Arguably, another role which such an agency could perform would be to simplify and co-ordinate the development of PPP schemes using a mix of national finance, EU Structural Funds and private finance. The evidence is that many administrations find it difficult to know how to start such a process. This is likely to remain even after the rules which govern the use of Structural Funds change for the period 2007-2013 when, for example, it looks likely that private finance will be allowed to count as an element of the matched national finance and that Structural Funds will be able to be used for the capital element of periodic availability payments made in a PPP.





## **CHAPTER 3**

### **PPP – The Policy Framework**

#### **OVERVIEW**

It would be easy to assume that the current PPP transaction structure which has developed and is established was inevitable or, more importantly, cannot be changed.

In fact, the current PPP model evolved through practice rather than being based a prior analysis of the approach which maximises the likelihood of whole-life value for money for the public sector. So it is very appropriate that it should now be reviewed, and legitimate to ask how well it serves the public sector's interests. As noted above, there are some aspects to it which may lead policy makers to conclude that the current structure of privately financed PPP is inherently disadvantageous to the public sector for some services.

In this review, there are a number of issues arising from the current market model which need to be considered. These include:

- The structure and operation of bid consortia
- The importance of risk valuation and transfer to the PPP decision
- The need to specify contract outputs in advance
- The extent and nature of risk accepted by lenders
- The commitment of investors to service delivery
- The scope of services included in PPP
- The timing of the involvement of lenders in the PPP award process
- Fiscal sustainability
- Whether or not the choice to use PPP is case specific and neutral
- The use of public sector guarantees.

This chapter analyses these issues and forms the basis for an assessment by policy makers at European and national level of how the policy framework might evolve.

## ANALYSIS OF POLICY FRAMEWORK

### Structure and operation of bid consortia

The type of consortium structure typically used in PPP raises a number of issues for Contracting Authorities i.e.:

- The extent to which the construction company investor remains committed to the delivery of the service after the construction phase is completed and will retain its share holding. Any desire for the widespread sale of equity stakes by construction company investors who have benefited from the contract to construct the asset could have implications for the commercial logic of PPP. As explained above (see p. 11), the best way to ensure that an asset is constructed in a way likely to promote whole-life value for money is to award a single contract which gives the winner responsibility for, and a financial interest in, the operation of the service/maintenance of the asset. Put simply, if construction companies are able to sell off their stakes after the completion of the construction phase, they are less likely to be motivated to construct an asset in a way which achieves whole-life value for money
- It becomes important for the Contracting Authority, as part of the selection procedure, to understand the internal working arrangements of the consortium, its proposed plans for distributing work amongst its members and/or third parties, including the risks they will be passing through and any arrangements which exist for rebalancing of equity shares/disposal of shares to other investors within the consortium. They will in particular want to be assured of the soundness of the management arrangements, the suitability and sustainability of the means by which the proposed technical solutions are to be delivered and, as regards the disposal of stakes, it is important because, in short listing a consortium, the public entity will be placing reliance on the qualifications of its members and, in the award process, the credibility and sustainability of their specific solution.<sup>98</sup>

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<sup>98</sup> Knowledge of the internal management arrangements of the consortium does not of course mean that the Contracting Authority should involve itself in the implementation of such arrangements. Nor should they accept interface issues between consortium members or between the SPV and third parties as a valid reason for the failure of service delivery.

## **The importance of risk valuation and transfer to the PPP decision**

The importance of the valuation of risks transferred to the private sector service provider, and thus avoided by the public sector, has been evident in that it is often the determining factor in whether or not many PPP have been deemed to represent value for money as compared to the alternatives. The UK NAO has, for example estimated that the value of risks transferred represents some 17% of the project cost in typical UK hospital projects.<sup>99</sup>

The use of private finance means that the financing costs will be higher than if the transaction were financed by public borrowing and, of course, the private sector operator will expect to make a profit. The commercial justification for such transactions thus rests on the extent to which:

- The private operator can deliver the service more efficiently than the public sector (i.e. lower costs for a given service level and/or, according to the nature of the service, higher revenues earned) *and passes on the benefit of it to the public authority in its bid price*
- The public authority benefits from the value of risks transferred to the private partner and thus avoided by themselves.

Risk valuation is an extremely complex business, both in respect of the valuation of the financial impact of the risk and the probability of its occurring. Further, at a conceptual level, the idea of the public sector explicitly identifying and paying for specific risks can be regarded as contradictory to the idea that governments do not insure risks but instead rely on the spread of their operations in effect to pool risks and cover them as they arise, which, because of the size and range of their operations and their ability to levy taxation, they are usually well placed to do.

## **The need to specify contract outputs in advance**

Some practitioners have argued that flexibility and a less clear initial definition of outputs should be built intrinsically into the structure of PPP in order to enable them to adapt to changing service need over the life of the transaction.

This is not just confined to professional advisers seeking to argue for such flexibility in order to maximise the extent to which public authorities will continue to need them to implement the contract, though the author has

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<sup>99</sup> See *Update on PFI debt refinancing and the PFI equity market*, Report of the Comptroller and Auditor-General, HC 1040, Session 2005-2006, 21 April 2006.

recently seen this argued in some well written marketing tools from professional advisory firms advocating this approach.

It is true that service needs do evolve over the life of long contracts i.e. a public authority might want more services, less services or a different balance of services. But to actively plan to maximise change during the life of the contract is to maximise the extent to which the contract terms are determined in circumstances where the public authority's bargaining position is at its weakest i.e. when there is no competition, thus potentially leading to poorer value for money. There is as yet no substantial evidence that other methods of securing value for money where there are contract changes or at agreed break points, such as benchmarking of sub-contractor services, use of a probity auditors or the use of a third party arbiter, have counteracted the basic position of weakness.

Put simply, if the contract outputs cannot be satisfactorily specified to a significant degree for the majority of the life of the contract, i.e. are likely to change materially, it would be more appropriate to consider whether or not PPP is the right form of transaction at all, if the public authority is in a financial position to exercise a real choice in this decision.<sup>100</sup>

Similar issues arise in new PPP models launched recently in the UK, such as Local Improvement Finance Trusts (LIFT) and Local Education Partnerships (LEP) which are arrangements for 20 and 10 years respectively. When these contracts are advertised, a given proportion, normally about one third of the total in the case of LIFTs, represents firm contractual arrangements and the remainder of the value represents schemes to be worked up by the parties during the contract period. These transactions raise two issues i.e.:

- Whether or not these are framework contracts, and, consequently, whether or not they justify the "exceptional circumstances, duly justified" for such contracts to exceed four years (see Art 32(2), Directive 2004/18)
- Even if they are not, there remains the question of whether or not the mechanisms of benchmarking of construction costs, service costs and profit margins used to determine if the contracts which were not the subject of firm initial tendering represent value for money are adequate to achieve this objective.

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<sup>100</sup> The UK government, for example, recognised this when determining that PPP should generally not be used for ICT projects (see *PFI: meeting the investment challenge*, HM Treasury, 2003, p. 87).

One of the claimed advantages of the approach adopted for LIFTs and LEPs is that it reduces bid costs and thus, indirectly, contract costs for the public sector. However there is a difficulty with transparency over bid costs, which makes this contention difficult to verify. In any case, this has to be set against the benefits to the public sector of transparent and competitive procurement in which, in the author’s experience, private partners, when faced with competition, are motivated to price contracts as keenly as possible. The inclusion of sunk bids costs from past contracts are not likely to improve the competitiveness of a bid for an individual contract, so, seen on a case by case basis, it is not clear that the absence or presence of competitive bidding increases contract costs. A more likely response to high bid costs not recovered from contracts won is complete withdrawal from the market, which may have implications at a certain point for the level of competitiveness in a market if there are a limited number of suppliers but not necessarily for individual project bids.

### **The extent and nature of risk accepted by lenders**

Lenders to PPP transactions tend to be highly risk averse. They will, for example, seek to enhance the security of their loan by:

- Capping the level of deductions from the periodic charge by the Contracting Authority
- Obtaining supports for the repayment of the loan by their borrower (the SPV), such as insurance and bank backed guarantees taken out by the SPV
- Ensuring that the SPV passes on the majority of risks to sub-contractors, which are also backed by the right to liquidated damages against sub-contractors and insurance and bank backed guarantees taken out by the sub-contractors, enforceable either by the SPV or the lenders directly
- Ensuring that they have the right to replace non-performing sub-contractors and if necessary their own borrowers
- Seeking to obtain direct agreements with the Contracting Authority covering matters such as the maintenance of service need and, in the case of transactions with sub-national government, to obtain assurances from national government that the sub-national entity has the *vires* to enter into the transaction and the obligation to pay their borrower if the services are delivered as contracted
- Ensuring that the loan to their borrower has covenants attached which require the borrower to maintain given levels of debt service cover (i.e. operating surpluses which exceed the loan repayments by a set amount)

and reserve accounts to cover loan servicing, asset refresh and maintenance costs and can restrict the ability of the borrower to make distributions to their shareholders in the event of failure to maintain the required levels of debt service cover.

They will also seek to secure repayment of their loan even in the event of the failure of the service provider. The precise scope of the payments to be made to a lender on termination in the event of failure by the service provider is a key question in determining how far PPP can provide value for money. On the one hand it seems to contradict the principle of risk transfer from the public sector that failure by the service provider should allow lenders to restrict their loss. On the other hand, PPP transactions generally create an asset which has a value even if the transaction is not fully completed, so that the absence of a termination payment could create an incentive for the public sector to engineer the failure of a contract to obtain an asset at an undervalue if there was no compensation at all for the lender i.e. there could be unjust enrichment for the public sector.

### **The commitment of investors to service delivery**

There are two aspects of current PPP transactions which raise questions about the equality of commitment to long-term delivery of public services by the public and private partners i.e.:

- The re-sale of equity stakes in PPP projects
- Re-financing of the original debt in PPP projects.

The re-sale of equity stakes in PPP changes the nature of the partners with whom the public sector has contracted and thus, as noted above, potentially undermines the rationale of the award procedure based on the capability of the original consortium composition and the structure of its offer. In effect, in the present model private partners are encouraged to treat PPP as financial transactions in which a small pool of rotating equity capital is used to extract relatively short term capital gains across a sequence of projects rather than being a long term investment in a project and in long term delivery of public services.

This is particularly the case where a stake in the service provider has been sold to a financial institution not connected with public service provision or to private equity investors. The transfer of ownership of service providers SPVs to private equity vehicles not listed on stock exchanges and therefore not subject to the disclosure requirements of listed entities, may

also raise questions of public accountability beyond those associated merely with other changes of ownership.

As regards debt refinancing, there have been some well publicised cases in the UK, for example those of the Darent Valley and Norfolk and Norwich hospital PFI schemes, where equity investors have dramatically increased their returns through re-financing once the construction phase had been completed and the risks considered by lenders to be lower (from 23% to 56% in the former case and from 19% to 60% in the latter case).

In pure financial terms these gains arise from the “gearing effect” i.e. the high ratio of debt to equity. This raises the question of whether or not such highly geared transactions are desirable, both from the point of view of the risks to the project (ability to repay debt) as well as the commitment to PPP of equity investors providing a relatively small share of total financing.

Model PFI contract terms in the UK now provide for gain sharing on re-financing by the public sector in some circumstances, but the issue is complex because it can involve an extension of the contract length with a consequent increase in the termination liabilities payable by the Contracting Authority in the event of early termination. As the UK NAO has noted,<sup>101</sup> half the refinancings have involved an increase in debt and most have resulted in an increase in termination liabilities. Even when there are gain sharing provisions there are potential difficulties because of the need to control exclusions from the provisions (such that of debt consolidation by service providers of debt from several PPP in a single financial instrument), the difficulty of calculating the refinancing gain, the difficulty of determining whether or not the increase in termination liabilities represents value for money and the desirability of increasing the length of already very long contracts.

More generally, the possibility for significant early refinancing gains may impact on the incentive of the service provider to continue to deliver the contract successfully, having taken most of the gain upfront. It is for those who advocate the desirability of permitting refinancings to demonstrate that any financial gains for the public sector which occur on refinancing outweigh the qualitative and financial disadvantages set out here.

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<sup>101</sup> See *Update on PFI debt refinancing and PFI equity market*, Report of the Comptroller and Auditor-General, HC 1040, Session 2005-2006, 21 April 2006, p. 24.



## **The scope of services included in PPP**

One of the key decisions to be made in PPP is to determine the scope of the services to be included in the transaction.

This is particularly the case in the health sector where, to date, the majority of PPP have generally been confined to accommodation services and have not included clinical services.<sup>102</sup> But a hospital PPP which excludes clinical services and is for accommodation and support services only is still subject to many of the same constraints. This is because changes in patterns of clinical services e.g. a shift from hospital based care to primary care, medical advances which render particular clinical services less or more in demand or deliver them in a different way, or, as is now the case in the UK, competition between hospitals as providers, may lead to changes in accommodation needs which the hospital authority is still committed to paying for in a PPP even though, within an individual hospital site, it may be partly mitigated by flexible design structures or flexible occupation arrangements for office accommodation.

In the end it may lead to the conclusion that there is sufficient interaction between clinical/educational services (and also, in the education sector, IT services) and facilities management services so that health and education PPP will include both elements. This is a policy decision which should in the author's view be made explicitly and transparently after debate, and not occur by default.

## **The timing of the involvement of lenders in the PPP award process**

The practice has developed, particularly in the UK, in which the lenders become seriously involved in the transaction (in the sense of making commitments to funding) at a late stage i.e. after the preferred bidder has been selected.

This approach is disadvantageous to the public sector, because at that stage its bargaining position is weak in the sense that it has eliminated competition and its only option is to abort the transaction if the negotiations lead to the deal being significantly less good value for money. In practice, this is a very difficult decision to take because of the time expended on it and emotional commitment made by the public authority to its completion (and sometimes political capital invested) and, of course, the fact that the transaction would presumably

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<sup>102</sup> Australia, Portugal and Spain are examples of countries where public authorities have or are seeking to experiment with the use of PPP for clinical services.

not have been initiated had there not been a need for the project.

This is a most unsatisfactory approach to a transaction. There might have been an argument for this approach when PPP transactions were relatively new and the lender market needed to be persuaded of the inherent commercial viability of non-recourse lending or in markets where PPP transactions are a new phenomenon and there may be doubts in the lender community about the financial sustainability of the borrower and/or their ability to enforce their legal rights to repayment of the loan where their borrower has performed the services contracted for and thus has a right to be paid for the service by the public authority. And some still seek to justify it where PPP are being used for a new type of service or in a complex way in a commonly used service. But, where, as is the case in the UK at the time of writing, more than 800 transactions have been completed across a wide range of public services, it is hard to argue that most of the risks are not already well understood at the time of initiating the transaction so that there is less justification for the accommodation of lenders’ needs to occur at a late rather than early stage of the transaction.

The fact that this approach still persists is, in the author’s view, mainly a matter of a lack of active market management. Put simply, if there is a publicly announced high intensity programme of public investment over a relatively short period of time, then clearly a government cannot afford for the lender community to be cautious about lending and thus there are the political risks of failure to complete promised programmes if it wishes to change the core assumptions of how transactions will be conducted. This does not, of course, necessarily make it commercially justifiable, or indeed, take account of the needs of future taxpayers for long term value for money.

For an individual public authority determining how to finance a transaction, however, it does mean that the way in which lenders engage with a PPP is a factor which it needs to take into account if it has a choice about whether or how much private finance is needed and the terms on which it is available.

A debate on financing of PPP is starting to emerge in the UK, with the issue of new guidance from the Treasury in August 2006 about the advantages of either requiring bidders to come with committed and not merely indicative terms of finance or of a publicly supervised funding competition by the preferred bidder to determine competitively the terms on which finance is provided. It remains to be seen if this approach – which in effect takes lenders out of the negotiation process – will represent a shift in the way in which the terms of contracts are determined, with the commitment of finance being integrated into the competitive procurement process, thus ensuring that private finance is provided on terms which represent value for money for the public sector.

## **Fiscal sustainability**

PPP are often structured so as to ensure that the borrowing to finance them is treated as private sector borrowing and thus does not appear as debt on the government balance sheet. In the author's experience this is rarely a justification which in itself is likely to lead to the optimum allocation of risks.

But compliance with the recommended disclosure requirements of the IMF e.g. future certain and contingent payment requirements, significant contract terms which could impact on cash flows, contract renewal and termination options, government guarantees e.g. of minimum revenues, demand for services and loan repayments to lenders), the right of partners to use assets, end of contract asset arrangements and the impact of the project on levels of public debt should allow for a proper assessment of the fiscal impact of PPP whether or not the assets are on the government balance sheet.<sup>103</sup> This is in any event important because of the attitude of the financial markets to the financial sustainability of a government's (or sub-national authority's) liabilities under PPP contracts. In practice they will make adjustments to the published data to reach their own assessment of such financial sustainability. Hence it is an important element of the management of an investment programme by a public authority to monitor the periodic assessment of credit rating agencies of the quality of its debt.

## **Whether or not the choice to use PPP is case specific and neutral**

It is fundamental to the effective use of PPP that a case by case analysis is made of whether or not PPP is the appropriate solution for an investment project. PPP should not be the default option for a project.

The opposite approach was in effect taken by the incoming British government in 1997 when, within a few weeks of coming into office, it abolished the so-called "universal test" which had required that every investment scheme should be tested for its potential for PPP. This was done, according to a Treasury news release of July 1997 to "accelerate the flow of PFI projects". The intention of this news release was that there was to be a presumption in favour of PPP for investment projects, an intention reinforced by the creation of the Treasury PFI Taskforce in September 1997.

Each PPP scheme would still be subject to a value for money comparison with alternative means of provision, a process known as the Public Sec-

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<sup>103</sup> For a fuller analysis, see *Public-Private Partnerships, Government Guarantees and Fiscal Risk*, IMF, 2006.

tor Comparator (PSC). But the commercial viability of PPP schemes as compared to the PSC often involves a series of highly subjective judgments about the value of risks transferred and many proceeded even though the advantage of the PPP over the alternative was often slight. These comparisons also often artificially inflated public sector costs for the so-called “optimism bias” i.e. the tendency for public sector schemes to exceed their budget but did not make a corresponding adjustment to the PPP scheme for the “lock-in factor” i.e. the cost of making changes to PPP contracts during their life when there was no competitive pressure or the “complexity factor” i.e. the uncertainty associated with complex transactions such as PPP.

There were clear political imperatives to this approach, i.e. the need of a party which had spent several years seeking to demonstrate its fitness for government through a commitment both to fiscal prudence and to market mechanisms. It remains to be seen whether or not, over the whole life of many of the PPP signed in the UK in recent years, the transactions will prove to be value for money.

### **The use of public sector guarantees**

Government guarantees, for example of loan repayments to lenders in the event of default of the SPV and revenue guarantees to the SPV, are ways in which the risks identified in a PPP and transferred to private sector partner could be mitigated.

It is a matter of judgment for Contracting Authorities whether or not any guarantees given are necessary, as part of the optimisation of the overall risk management framework and the willingness of service providers and lenders to accept risk. Part of this consideration will be the need to consider the “moral hazard” risk of government guarantees i.e. that they encourage over-optimistic bids by service providers in the expectation that the project will be rescued by the public sector.

There are a number of guidelines which a Contracting Authority should follow in determining whether or not to offer guarantees:

- In general, the more mature the market for a service i.e. the better the risks have been tested in practice, the less need there should be for guarantees
- Loan repayment guarantees should be the minimum necessary to enable the project to proceed, should be invoked in such a way as to require the lender to bear an agreed share of the loss, should be properly valued and be transparently accounted for
- Where minimum revenue guarantees are given, these should be mir-

- rored by upside gain sharing for the public sector
- Any guarantees given should relate only to risks specific to the project and not against events which impact on the economy as a whole.

From the point of view of fiscal sustainability the total value of guarantees given in PPP should be controlled centrally i.e. by national government because of the expectation that national government will support sub-national government where a PPP guarantee is called.

# CHAPTER 4

## PPP – The Legal Framework

### OVERVIEW

As noted above, the current legal framework within which PPP are awarded falls is that of the Public Procurement Directives. These apply to PPP even though PPP are not explicitly referred to in them (except for concessions, which are one form of PPP).<sup>104</sup>

There is no reference in the EU Treaties to public procurement (or to PPP) and there is no specific reference to them in other areas of EU secondary legislation. However, the award of PPP does have to be consistent with Community law in respect of state aid and, though public procurement falls within the ambit of Internal Market competence rather than that of competition law, wider competition issues.<sup>105</sup>

This chapter addresses five elements key to the effective implementation of PPP. The selection of these elements is based on the assessment that the legal framework for PPP needs to be enhanced, thus enabling PPP to be used more effectively. The specific enhancements needed are to create greater legal certainty for the parties to the transaction and greater clarity about the obligation to conduct a transparent and competitive procurement process.

**Legal certainty**<sup>106</sup> is particularly important in attracting interest in long term, high value contracts such as PPP, which often call for high levels of investment by service providers and long term financial commitments by Contracting Authorities.

The need for **transparent and competitive procurement** derives from

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<sup>104</sup> The fundamental principles of the EC Treaty and the principles relevant to public procurement which derive from those Treaty principles do, of course, apply to PPP. In this context the most directly relevant principles are those of freedom to provide services, freedom of establishment, equality of treatment, non-discrimination and transparency.

the pressures on public authorities. They need to procure significant infrastructure development as quickly as possible to comply with EU legislation and to meet the service expectations of citizens as consumers with ever higher service expectations. When they are also faced with severe budgetary pressures it is particularly important to ensure that value for money is achieved through transparent and competitive procurement.

The specific elements of the legal framework addressed here are the legal forms which PPP can take, the current scope of application of the Public Procurement Directives to different legal forms of PPP, recent developments relevant to the legal framework for PPP, the Competitive Dialogue award procedure (introduced into the Public Procurement Directives to make the use of PPP easier) and the application of the rules relevant to PPP after the selection of the private partner.

## **THE LEGAL FORMS OF PPP**

Since PPP transactions fall within the scope of the Public Procurement Directives, they can only fall into one of four legal forms, i.e., a works contract, a works concession, a service contract or a service concession.

A “public works contract” is defined by the Public Procurement Directives<sup>107</sup> as “public contracts having as their object either the execution, or both the design and execution, of works related to one of the activities within

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<sup>105</sup> The Commission examined the financial arrangements for the London Underground PPP in some detail to assess whether or not there was a cause for action before finally determining that there was not. In general terms, a public authority which designs a PPP with the intention of awarding it by a transparent and competitive procurement process, including with clearly defined objectives, thus rendering it unlikely to pay in excess of the market value for the works and services, and then actually does so, will not fall foul of EU state aid rules. If this is not the case, then, to promote legal certainty, it would be highly desirable that the Commission remove any doubt in this matter. State aid issues which may arise during the contract execution phase are considered further below.

The principal broader competition law issues which arise in markets within which PPP are awarded are those relating to the abuse of a dominant market position. These are, as noted above, connected with both state ownership of providers, which can in some cases distort competition particularly when they operate outside the geographical or sectoral area within which they have been granted a monopoly and the market consolidation which has been observed amongst private sector providers where markets have been opened to private provision, for example in sectors such as water supply and other environmental services. These issues can be largely addressed by effective coordinated market management by the public sector, of which the key idea is that no market should be dominated by the public or private sectors and that good value for money is achieved by maintaining tension between them.

the meaning of Annex I (of the Directive)”.<sup>108</sup>

A “public service contract” is “a public contract other than a public works or supply contract having as its object the provision of services referred to in Annex II (of the Directive)”.<sup>109</sup>

A works concession is defined as “a contract of the same type as a public works contract except for the fact that the consideration for the works to be carried out consists either solely in the right to exploit the work or in this right together with a payment”.<sup>110</sup>

A service concession is defined as “a contract of the same type as a public service contract except for the fact that the consideration for the provision of services consists either solely in the right to exploit the service or in this right together with a payment”.<sup>111</sup>

Thus, the definition of a works and a service concession is derived from that for works contracts and service contracts. Public contracts and concessions differ only in respect of the extent of risk borne by the private partner i.e. the extent to which payment for the transaction is certain.

At its most straightforward, if a private partner is engaged to build and operate a road and is paid a fixed sum for its construction and a management fee for its operation, then the transaction is clearly a public contract.

On the other hand, if the private partner’s remuneration is solely from the tolls paid by users of the road, without any subsidy by the commissioning authority paid to the private partner to reduce the level of toll charges or

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<sup>106</sup> As defined above in note 9, i.e. the assurance that the process will, if conducted according to known and well defined rules, lead to an outcome which is unlikely to be successfully challenged. In the context of this chapter, dealing also with PPP during the contract execution phase, legal certainty also means that the parties are clear how the contract should be executed in such a way as not to attract challenge during the execution of the contract.

<sup>107</sup> Art 1(2)(b), Directive 2004/18.

<sup>108</sup> The need to define a works contract is an anti-avoidance measure derives from the fact that the threshold above which works contracts are subject to advertisement in OJEU is much higher than that for service contracts. For works contracts the threshold is currently €5,278,000 and for service contracts – depending (with some exceptions) on whether or not the Contracting Authority is a central government entity – either €211,000 or €137,000. A “work” is further defined to mean the outcome of building or civil engineering works taken as a whole which is sufficient of itself to fulfil an economic or technical function.

<sup>109</sup> Art 1(2)(d), Directive 2004/18. The definition also includes a provision, again for anti-avoidance purposes, that a public contract having as its object services within the meaning of Annex II and including (works) activities within the meaning of Annex I that are only incidental to the principal object of the contract shall be considered to be a public service contract.

<sup>110</sup> Art 1(3), Directive 2004/18.

<sup>111</sup> Art 1(4), Directive 2004/18.



without any minimum revenue guarantee to the private partner from the public authority, then the transaction is clearly a concession because the private partner is taking the exploitation risk.

But, to continue with the toll road example, matters are not often as straightforward as this, and the extent to which a private partner is accepting risk may not be so clear as to determine whether or not a transaction is a public contract or a concession. It will be influenced by matters such as the level of any subsidy to reduce toll charges, the extent of any minimum revenue guarantee, the length of the period of private operation, which may be framed in terms of a fixed period of time or in terms of the time needed for the private partner to recover its investment and an agreed profit in net present value terms, and the arrangements in place in the event of the early termination of the arrangement by either party.

In fact, there is no objective definition of how much risk a private partner must accept for the transaction to be classified as concession as opposed to a public contract. As is clear from the definitions in Art 1(3) and Art 1(4) of Directive 2004/18, the fact that the private partner is guaranteed to receive a pre-agreed amount of payment in addition to the right to earn other income of which the level is not guaranteed does not, *per se*, prevent the transaction being classified as a concession. But, clearly, if the extent of the guaranteed amount were to be, say, 60% of the total expected income of the private partner, this would raise questions about the extent to which the private partner was accepting risk.

Nor can a public authority wishing to determine whether or not a transaction is a public contract or a concession find the matter resolved by the recent decision<sup>112</sup> of Eurostat. This is designed to provide a common framework to determine, for the purpose of national accounting, whether or not a transaction should be counted as part of government debt i.e. whether or not it is an “on-balance sheet” or “off-balance sheet” transaction.

The Eurostat decision states that the debt should be treated as off-balance sheet if the private partner accepts the construction risk and either the demand risk *or* the availability risk. But part of the commercial logic of PPP, and distinguishing it from traditional procurement, is that the private partner will bear the burden of any cost and time overruns in the construction phase<sup>113</sup> (the construction risk) and will, continuing with the road example, not be paid until the road is available for use and will suffer deductions from

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<sup>112</sup> New decision of Eurostat on deficit and debt, *Treatment of public-private partnerships*, 18/2004.

<sup>113</sup> Except, of course, for those resulting from changes in specification by the public authority.

income if the road is wholly or partly temporarily unavailable for use during the period of its operation (the availability risk). But, even having passed these two tests, and classified the transaction as “off-balance sheet”, the amount of payment to the private partner could still vary according to the extent to which it is accepting the demand risk. So, the classification of a transaction as off-balance sheet in terms of the Eurostat opinion is not definitive in terms of assessing whether or not a transaction is a public contract or a concession.

In terms of the legal framework for the award of PPP, the significance of the need to determine the correct legal form of the PPP is, as explained below, that there are differences in the extent to which the Public Procurement Directives apply to the four different legal forms for PPP (with a further refinement in the case of service contracts according to the nature of the services being procured).

Crucially, it is also possible that the precise distribution of risk, and thus the classification of the legal form of the transaction as a public contract or as a concession, may change during the award process from that envisaged by the public authority at the start of the transaction. This could happen, for example, as a result of negotiations with potential private partners forming part of the dialogue phase of a Competitive Dialogue procedure.

Hence there is a possible risk that a public authority could fail to apply parts of the Public Procurement Directives relevant to the transaction – and, in particular, applying only those which apply to concessions, which are less regulated than public contracts, where the transaction is in fact a public contract. In doing so they could thus be subject to the risk of legal challenge, an increased risk given the increasing number of cases dealt with in the field of public procurement by the ECJ and national courts.<sup>114</sup>

## **SCOPE OF APPLICATION OF PUBLIC PROCUREMENT DIRECTIVES TO DIFFERENT LEGAL FORMS OF PPP**

### **Current rules relevant to the legal framework for PPP**

As noted above, there are differences in the extent to which the Public Procurement Directives apply to the four different legal forms for PPP.

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<sup>114</sup> There is nothing, of course, in the Public Procurement Directives to prevent a public authority from applying the more widely drawn regulations for public contracts even where the transaction is a concession. This is common practice in the UK and helps to reduce the risk of misapplication of the Public Procurement Directives.

Public works contracts above the threshold<sup>115</sup> for advertisement in the OJEC are subject to the full scope of the Public Procurement Directives. This means that they have to comply with the provisions of the Public Procurement Directives relating to the entire procurement process, including the rules for:

- Contract valuation
- Non-discriminatory technical specifications
- Advertising
- Time limits for different phases of the process
- Permissible short list criteria
- Rules regarding short listing
- Permitted award bases
- Permissible award criteria
- Publicity about the award through the publication of contract award notices
- Rules relating to sub-contracting and performance conditions etc.

Public works concessions are less tightly regulated than public works contracts in Directive 2004/18 (Art 56 to 65) – but are bound by rules on contract valuation, advertising, time limits for expressions of interest, additional works awarded to concessionaires, sub-contracting and rules for when the concessionaire lets contracts to third parties.

Public service contracts above the thresholds<sup>116</sup> are subject to the full scope of the Directives if they fall into the categories defined in Annex IIA of Directive 2004/18 (“priority or Part A services”).

Public service contracts above the thresholds are subject only to rules on the need for non-discriminatory technical specifications and publicity about the award through the publication of contract award notices if they fall into the categories defined in Annex IIB of Directive 2004/18 (“non-priority or Part B services”).<sup>117</sup>

By contrast, service concessions are completely excluded from the scope of Directive 2004/18 (Art 17), as, indeed, they were from the scope of the former Public Services Directive. This means also that bidders in a PPP defined as a service concession do not have to access the specific remedies referred to in the Public Procurement Remedies Directive and must rely on

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<sup>115</sup> The threshold is set out in Art 7, Directive 2004/18 and is currently €5,278,000, subject to revision every two years to ensure consistency with World Trade Organisation thresholds. The amounts expressed in euros have published equivalents fixed for two years in national currencies of EU Member States which have not adopted the euro.

<sup>116</sup> Art 21, Directive 2004/18.

<sup>117</sup> *Ibid.*

seeking remedies based on breach of the general principles of the EU treaties such as freedom of movement of goods, freedom of establishment, freedom to provide services and mutual recognition.<sup>118</sup>

This raises the question at a European policy level, whether or not these differences in award procedures can be justified.

Further, all transactions, irrespective of the extent to which the Public Procurement Directives apply to them, are bound to respect general EU Treaty principles set out above and the principles relevant to public procurement derived from them i.e. non-discrimination, equality of treatment, proportionality and transparency.<sup>119</sup>

But, notwithstanding the Public Procurement Directives, there is some degree of legal uncertainty about precisely what obligations are imposed by EU Treaty principles on public authorities which seek to award PPP which are not subject to the full rigours of the Public Procurement Directives. In the context of PPP, this relates principally to situations where the subject is Part B services or it is classed as a service concession.

There are significant differences of approach in these circumstances in different EU Member States – in the UK for example, there is a tendency to apply full regulation of the Public Procurement Directives even when this is not strictly required (and which, as noted above, is not, of course, prevented by the Public Procurement Directives).

As noted in Recital 19 of Directive 2004/18, Part B services are potentially subject to reclassification as fully regulated services but not within any particular timescale. These services include education and health, which are now being increasingly delivered through forms of PPP in several EU Member States, and are attracting cross-border interest. Hence they are becoming of increasing relevance to the EU Internal Market, thus reinforcing the argument for considering re-classification of these services.

European Court of Justice (ECJ) cases have started to define the obligations of Contracting Authorities in case law, notably in the *Telaustria* case in which the ECJ referred to “[the] obligation of transparency which is imposed on the Contracting Authority consists in ensuring, for the benefit of any potential tenderer, a degree of advertising sufficient to enable the services market to be opened up to competition and the impartiality of procurement procedures to be reviewed”.<sup>120</sup>

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<sup>118</sup> Because Treaty principles are, by definition, elaborated in less detail than specific obligations under secondary legislation, there is less clarity about the circumstances in which they may be available. The purpose of introducing specific remedies directives in the first place was precisely because of the difficulty in obtaining remedies based on EU Treaty principles.

<sup>119</sup> See Recital 2, Directive 2004/18.

The Commission has expressed the view<sup>121</sup> that the rules resulting from the relevant provisions of the EC Treaty can be summed up in the following obligations:

- Fixing of the rules applicable to the selection of the private partner
- Adequate advertising of the intention to award a concession
- Rules governing the selection in order to be able to monitor impartiality throughout the procedure
- Introduction of genuine competition between operators with a potential interest and/or who can guarantee completion of the tasks in question
- Compliance with the principle of equality of treatment of all participants throughout the procedure, selection on the basis of objective, non-discriminatory criteria.

Where applicable Community law is derived primarily from general Treaty obligations there is no coordination of the legislation of Member States. In addition, and although the Member States are free to do so, very few have opted to adopt national laws to lay down general and detailed rules governing the award of works or services concessions.

### **Recent developments relevant to the legal framework for PPP**

The latest update of Public Procurement Directives occurred in March 2004 – a process which took nearly four years to complete from the date of the original Commission proposal for draft directives – and the deadline for their transposition into national law was 31 January 2006.

However, the conclusion of the legislative process for the Public Procurement Directives marked only the start of a process which could lead to further changes in the legal framework for PPP.

The key recent developments since that date (described below) have been:

- The publication by the European Commission of a consultative Green Paper in April 2004<sup>122</sup>
- The publication of the results of the consultation in May 2005<sup>123</sup>
- The publication of the political conclusions arising from the consulta-

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<sup>120</sup> ECJ Case C-324/98, at para 62.

<sup>121</sup> See *The PPP Green Paper*, p. 11.

<sup>122</sup> *The PPP Green Paper*.

<sup>123</sup> *Report on the public consultation on the Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions*, Commission Staff Working Paper, SEC (2005) 629.

tion in a Commission Communication in November 2005<sup>124</sup>

- The launch of further impact studies re the legal framework for PPP
- An Explanatory Note from the Commission on Competitive Dialogue published in January 2006
- Proposed amendments to Public Procurement Remedies Directives in May 2006.<sup>125</sup>

It is not yet clear to what extent this process will change the legal framework for PPP, but the nature and scope of the process, and the issues which it addresses mean that change is likely.

The PPP Green Paper published by the European Commission launched a consultation (at the request of stakeholders as well as the European Parliament and EU Economic and Social Committee) designed to launch a debate on the application of EU law on public contracts and concessions to PPP. The PPP Green Paper analysed the current legal position of PPP in Community law and posed a number of questions on which it invited the opinion of stakeholders.

In the author’s opinion, this was a well directed Green Paper in the sense that it included most of the key issues to be addressed and was not restrictive, creating space for stakeholders to comment on other matters. There was no prior commitment to any specific type of legislative action by the Commission as a result of the consultation process and, indeed, there were specific references in the Green Paper to non-legislative instruments. The Commission repeated its often stated position that it makes no judgement about whether or not PPP are an appropriate solution for service delivery generally or in specific cases.

The key issues addressed in the consultation were:

- Will the use of the Competitive Dialogue procedure prove to be well adapted for use in award processes of public contracts involving PPP?
- Does the existing legal framework for award of concessions normally guarantee genuine competition and is an EU legislative initiative needed to regulate the award of concessions?
- Does the existing legal framework for award of concessions facilitate effective participation by non-national operators?
- Should all contractual PPP be bound by the same rules re award procedure whether they are public contracts or concessions?

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<sup>124</sup> *The PPP Communication.*

<sup>125</sup> *Proposal for a Directive of the European Parliament and the Council amending Council Directives 89/665/EEC and 92/13/EEC with regard to improving the effectiveness of review procedures concerning the award of public contracts, COM (2006), 195 final, European Commission, May 2006.*

- How should Contracting Authorities manage award processes following “private initiative” PPP to ensure compliance with the principles of transparency, non-discrimination and equality of treatment especially for non-national operators?
- Are there widespread cases of significant conditions in the contract underlying the PPP or adjustments during its life which might undermine principles of freedom of establishment and freedom to provide services?
- Is the Commission right to think that step-in arrangements and replacement of the private partner without competition (or any other common contract clauses) may cause issues of transparency and equality of treatment?
- Is there a need for an initiative to clarify or adjust the rules on sub-contracting?
- Is there any evidence of any other common breaches of EU law on public contracts and concessions in the creation of institutional PPP? (and particularly where capital injection might conceal the award of contracts to a private partner)
- Is there a need for a legislative initiative to clarify or define the obligations of Contracting Authorities regarding competition for participation in institutional PPP?

The PPP Green Paper resulted in a significant response i.e. 195 replies (31 government/sub-national authorities, 111 associations, 38 enterprises, 13 individuals, EU Committee of Regions, EU Economic and Social Committee), though the replies were unevenly distributed across the EU. A significant number came from UK, Italy, France, Germany and Austria, while there no replies – either from State authorities or from private entities – from Cyprus, Estonia, Greece, Hungary, Latvia, Luxembourg, Malta or Slovenia. A summary of the results of the stakeholder consultation was published in May 2005 in a Commission Staff Working Paper.<sup>126</sup>

The key conclusions of the stakeholder consultation were that:

- A slight majority of respondents were opposed to a horizontal EU PPP initiative
- Competitive Dialogue was expected to be well suited to awarding public contracts, while safeguarding rights of economic operators. But a large majority of stakeholders pointed to practical problems with its applica-

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<sup>126</sup> *Report on the public consultation on the Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions*, Commission Staff Working Paper, SEC (2005) 629.

- tion and sought Commission clarification
- A clear majority of respondents were in favour of EU initiative on award of concessions, clarifying definitions and Community rules but there was no consensus on the form of the initiative
  - Non-national operators were generally believed to be guaranteed access to private initiative PPP schemes and that advertising of them is adequate
  - Some sort of encouragement for private initiative PPPs was favoured by many stakeholders
  - A majority of respondents did not support an EU initiative on contractual framework for PPP and few reported discrimination or barriers to freedom of establishment or to provide services through conditions of execution or discrimination in evaluating tenders
  - There were mixed views about an initiative on subcontracting – some argued against new initiatives, while others highlighted reduced control for public authorities over sub-contractors and the position of sub-contractors vis-à-vis the main contractors
  - There was no consensus on whether or not Community law on public contracts and concessions is actually complied with when institutional PPP are created
  - There was concern re lack of legal certainty at EU level re what constitutes an “in-house” entity i.e. precisely when a public authority can award a contract without the application of the Public Procurement Directives to an entity which is legally separate from it but which it effectively controls.

In principle, the Public Procurement Directives apply whenever a public body awards “a contract for a pecuniary interest in writing” (Art 1(2)(a), Directive 2004/18). There cannot be a contract between legally indistinct entities i.e. a body cannot contract with itself. Public authorities and their representatives have sought to argue that a municipal enterprise effectively controlled by it is not legally distinct. The ECJ, in a series of recent cases, notably the *Teckal*,<sup>127</sup> *Stadt Halle*,<sup>128</sup> *Coname*,<sup>129</sup> *Parking Brixen*<sup>130</sup> and *Carbotermo* cases, have increasingly sought to define the circumstances in which an exemption from the Directives applies for contracts awarded to controlled municipal enterprises. Municipal enterprises are also concerned about the impact of a recent ECJ judgement (*Commission v Spain*<sup>131</sup>), on the

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<sup>127</sup> C-107/98.

<sup>128</sup> C-26/03.

<sup>129</sup> C-231/03.

<sup>130</sup> C-458/03.

<sup>131</sup> C-84/03.



application of the Public Procurement Directives to co-operative arrangements between sub-national authorities

- A clear majority of contributions argue for EU level initiative to clarify or define the obligations of contracting bodies re competition between operators potentially interested in an institutional PPP. There was no consensus on the form of such an initiative
- Too many and too strict rules are seen as an obstacle to the development of PPP
- There was near unanimous support for a collective consideration of PPP issues at EU level.

The political conclusions arising from the stakeholder consultation were published in a Commission Communication in November 2005.<sup>132</sup>

The key conclusions of the Communication were that:

- There was a need for clarification by the Commission on the application of the Competitive Dialogue procedure. This new award procedure was introduced by the Public Procurement Directives measures to make the application of PPP easier, though opinions are divided about how far it will achieve this effect
- There was no need for new legislation covering all contractual PPP<sup>133</sup>
- There was no need for Community action on other aspects of PPP e.g. the contract execution phase
- There was need for greater legal certainty on the award of concessions, with the preferred means being a legislative initiative, the need for which was to be subject to an impact study
- There was need for further clarification re the legal framework for the award procedure for IPPP, with the preferred means being an Interpretative Communication.

As noted above, the key question centres around whether or not different treatments for PPP which are public contracts and those which are classified in the Directive as concessions can continue to be justified. There is a clear risk that diversity of practice and lack of co-ordination of national legislation in the award of PPP in EU Member States could act as a barrier to competition, to the ability of public authorities to procure infrastructure development competitively and to the development of the public procurement component of the EU Internal Market. This is significant, given that

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<sup>132</sup> *The PPP Communication.*

<sup>133</sup> i.e. that there would not be separate PPP legislation introduced to the EU legislative framework which was distinctive from that for public procurement.

the Commission has already highlighted public procurement as an area lagging behind in implementation of the EU Internal Market.<sup>134</sup> In addition, challenge on the grounds of using the wrong award procedure (and thus the uncertainty of legal outcome) is an increased risk given the increasing number of cases dealt with in the field of public procurement by the ECJ.<sup>135</sup>

But, having developed the analysis – the Commission highlighted in the Green Paper that in some transactions it has not been easy at the start of an award process to be sure whether they are a public contract or a concession and that the initial definition might change as a result of negotiations<sup>136</sup> – it then concluded in the Communication<sup>137</sup> that there was “significant stakeholder opposition to a regulatory regime covering all contractual PPP” (public contracts and concessions) and therefore “the Commission does not envisage making them subject to identical award arrangements”.

Elsewhere in the Communication<sup>138</sup> there is a recognition of the need for a stable, consistent legal environment for the award of concessions, particularly to enhance competition, that general EU treaty principles do not provide enough legal certainty in the award of concessions and that it is “difficult to understand why service concessions which are often used for complex and high value projects are entirely excluded from EU secondary legislation”.

There is in fact little justification for these different treatments for PPP which are public contracts and those which are classified in the Directive as concessions. Treaty principles themselves do not provide sufficient justification and nor does the potential existence of additional risk to the supplier in a concession.

The existence of different procedures also creates opportunities for the avoidance of transparency and competition in procurement in the way that the contract is structured, especially as many PPP are capable of being classified as service concessions. This avoidance of transparency and competition in procurement could have an impact on the ability of public authorities to procure infrastructure development at a price which represents optimal value for money.<sup>139</sup>

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<sup>134</sup> See, for example, *Internal market strategy – Priorities 2003-2006*, European Commission, May 2003, pp. 17-19.

<sup>135</sup> 95 public procurement cases decided by the European Court of Justice between 1995 and 2004 as compared to 31 between 1985 and 1994, and 17 further cases in 2005.

<sup>136</sup> *The PPP Green Paper*, p. 12.

<sup>137</sup> *The PPP Communication*, p. 5.

<sup>138</sup> *Ibid*, p. 7-8.

<sup>139</sup> For the same reasons – i.e. the need to avoid a multiplicity of procedures – sectoral and sub-national legislation is also undesirable.

The author's view is that the most straightforward way of bringing about legal certainty in this field is the solution which the Commission appears to have ruled out i.e. making public contracts and all concessions subject to identical award arrangements. In effect this would render the distinction between public contracts and concessions redundant.

Nevertheless, if a new legislative initiative includes, as the Commission suggests in the Communication that it might,<sup>140</sup> both works and service concessions this would at least bring service concessions within the scope of EU secondary legislation.

If the scope of a new legislative initiative is merely to bring service concessions within the scope of EU secondary legislation the most straightforward way of doing so is to repeal Art 17, Directive 2004/18 (which currently excludes them) and to extend the scope of the articles which refer to works concessions also to include service concessions. This would have the merit of not creating new procedures with new requirements for concessions, and thus not add to the scope for "régime shopping" i.e. structuring the transaction so as to be able to use an award procedure with the intention to avoid transparent and competitive procurement. This danger could arise if the legislative initiative were to take the form of a separate directive for concessions.

The impact study on the need for a possible legislative initiative for concessions was expected to take most of 2006 to conduct and to be assessed by the Commission. Clearly, the terms of reference and the methodology finally agreed for the study are crucial. Presumably, the key criterion for determining possible future courses of action will be their impact on the application of Treaty principles and of the principles of the Public Procurement Directives derived from those Treaty principles. But it is difficult to see how, objectively, it can be possible to assess and compare the impact of legislative as opposed to non-legislative initiatives and of different types of legislative initiatives against this criterion. If the conclusions are to be based primarily on the opinions of stakeholders, it is doubtful that the impact study will reveal anything which the consultation prior to the Communication (or the arguments advanced in the lengthy process of agreeing the new Public Procurement Directive) did not reveal. This is particularly true given that the impact study was to be based closely on stakeholder consultation.<sup>141</sup>

The first fruit of the November 2005 Communication was the Commis-

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<sup>140</sup> *The PPP Communication*, p. 8.

<sup>141</sup> It is in fact not easy to visualise what else an *ex ante* impact study on the applicability or not of a given law could be based on, given the difficulty of finding a parallel example in this domain.

sion’s Explanatory Note on Competitive Dialogue published in January 2006.

This Explanatory Note was a useful contribution to the application of the procedure though it does not answer all the questions which will arise in practice about the implementation of Competitive Dialogue – many of these will be resolved as the procedure is used in practice. But there are some particularly useful pointers to the application of the procedure e.g. Note 21, which draws attention to a way in which Contracting Authorities can create the conditions for developing hybrid solutions,<sup>142</sup> Note 23, which could be taken to mean that the fears of the supplier market of the impact of cherry picking are exaggerated and Note 35, which could be interpreted as highlighting the distorting effect of considering the requirements of funders only when there is, in effect, a single tender environment.<sup>143</sup>

The Explanatory Note could also helpfully be supplemented by practical guidance to further tighten and restrict what is and is not possible in the post tender period by defining more closely terms such as “clarifying, specifying and fine tuning” tenders, “clarifying aspects of the (winning) tender” and “confirming commitments contained in the (winning) tender”.<sup>144</sup>

This further guidance would reinforce the intention of the Competitive Dialogue procedure, which is to enshrine current good practice and minimise the extent to which changes are made to the contract after tenders have been submitted and even more so after the selection of the winning tender.<sup>145</sup>

In May 2006<sup>146</sup> the Commission also proposed amendments to Public Procurement Remedies Directives. These Directives, which date from 1989

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<sup>142</sup> i.e. using the dialogue phase of the Competitive Dialogue procedure to merge the best features of the solutions of different bidders, and develop the optimal solution. This is explicitly permitted by the Directives where bidders have waived their right to confidentiality. The author’s experience has led him to advance similar arguments elsewhere – in an unpublished submission to the then DG XV – given that in reality there is little evidence that such fears have in reality acted as a barrier to participation by private partners in award procedures. See *The proposed Competitive Dialogue procedure for EU public procurement – some practical considerations*, June 2000, p. 6.

<sup>143</sup> This is a valid given that there have been enough PPP/PFI schemes in most sectors – 800 in UK alone – for the treatment of most of the risks most of the time to be capable of being standardised and thus pre-cleared with potential lenders while there is still competition for the contract.

<sup>144</sup> See Art 29, Directive 2004/18.

<sup>145</sup> The author has argued elsewhere that the effective implementation of the Competitive Dialogue procedure would be enhanced by further technical guidance the Commission in a range of different areas of the procurement and contract management process. See unpublished submission to the then DG XV, *The proposed Competitive Dialogue procedure for EU public procurement – some practical considerations*, June 2000, pp. 6-7.

in the public contracts sector<sup>147</sup> and 1992 in the utilities sector,<sup>148</sup> set out how those dissatisfied with the conduct of a public procurement exercise can gain redress. Several ECJ cases and Commission infringement procedures against Member States have highlighted many aspects of the diversity of practice across the national legal systems of the EU. This can make it more difficult for aggrieved bidders to gain redress when things go wrong.

When launching the consultation on possible changes to the Remedies Directive, the Commission referred to “the unsatisfactory situation brought about mainly by the very heterogeneous operation of Member States national review procedures, and recent developments in case law require clarification of or greater precision in the existing legislative framework, in order to ensure that there are sanctions which are effective and proportionate and which have a deterrent effect on infringements of Community law on public procurement, especially the most serious infringements (direct award of contracts without prior notification)”.

But it then went on to say that “any amendments should merely adapt and improve certain provisions of the Remedies Directives, without altering the philosophy and principles which underlie them. For example, the principle of the Member States procedural autonomy will not be called into question. Member States will, in particular, retain the power to select a court, tribunal or independent authority competent to hear challenges relating to Community law on public procurement in accordance with their national law”.

The proposed reform of the Remedies Directive aimed to address two abuses which the Commission identified as significant in its impact assessment report accompanying the revised Remedies Directive.<sup>149</sup>

Firstly, the direct award of contracts without advertisement i.e. inappropriate use of the provisions of Art 31, Directive 2004/18, which allows for the award of a public contract by negotiation without publication of an

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<sup>146</sup> *Proposal for a Directive of the European Parliament and the Council amending Council Directives 89/665/EEC and 92/13/EEC with regard to improving the effectiveness of review procedures concerning the award of public contracts*, COM (2006), 195 final, European Commission, May 2006.

<sup>147</sup> *Council Directive 89/665/EEC of 21 December 1989 on the coordination of the laws, regulations and administrative provisions relating to the application of review procedures to the award of public supply and public works contracts* (referred to hereafter as the Remedies Directive).

<sup>148</sup> *Council Directive 92/13/EEC of 25 February 1992 coordinating the laws, regulations and administrative provisions relating to the application of Community rules on the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors*.

<sup>149</sup> SEC (2006) 557, May 2006.

OJEU contract notice. This procedure is meant to be limited to exceptional circumstances.

Secondly, the absence of an opportunity for aggrieved bidders to challenge the award of a contract before it has been concluded. This has occurred because in some jurisdictions the contract is deemed to be concluded when the parties are advised of the award decision. This may then leave the aggrieved losers only with the option of seeking damages if the Member State has exercised the option in the current Remedies Directive of limiting the available remedies to damages once the contract has been concluded. Seeking damages is unsatisfactory in a number of ways i.e. there are different bases of valuation (loss of profits, bidding costs incurred, some element of opportunity cost etc.) and uncertainty about precisely what the plaintiff has to prove i.e. that they would have won the contract or that they might have won the contract and how they would do this. This often needs a lengthy and potentially expensive court case.

The ECJ, in the *Alcatel Austria* case,<sup>150</sup> highlighted the importance of ensuring the effective application of the Public Procurement Directives at the stage when the infringement can still be rectified. The solution, now carried forward into the revised Remedies Directive, is a requirement in most cases for a reasonable period between the notification of the contract award and contract conclusion. It is proposed that there will be a standstill period when losing bidders are notified of the outcome and have a period within which they can still lodge a challenge at a time when it is possible to obtain a remedy other than damages i.e. to amend the contract award decision.<sup>151</sup>

The practical outcome of the proposed changes to the Remedies Directive is likely to be an increase in the number of challenges to procurement procedures if the evidence of the countries where standstill procedures have been used in the past is replicated EU-wide. It is reasonable to expect that these challenges will be prominent in high value, high profile procurements like PPP.

But this is not a fundamental reform of the implementation of remedies which is needed to reduce diversity in procedures for remedies and diversity in the availability of particular remedies. Such a reform would remove one potential barrier to cross-border bidding and act as a force against the fragmentation of the Internal Market. This has the potential for a significant impact on PPP which, being high value, are more likely to attract EU-wide

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<sup>150</sup> C-81/98.

<sup>151</sup> For a more detailed analysis of the Commission’s proposals see Liisa Koskinen, “Reform of Public Procurement Remedies: A First Look at the Commission Proposal for an Amending Directive”, *EIPASCOPE*, 2006/3, December 2006.

competition.

Some of the areas in which the options for Member States could be restricted to provide greater certainty for bidders include:

- Specifying the procedural rules applicable to reviews (such as the requirements for administrative and judicial review bodies and the access to relevant information by the plaintiff)
- Determining what the plaintiff has to prove when seeking damages e.g. the likelihood that they would have won the contract or that they might have won the contract and how this can be done
- Standardising the basis for calculating damages. Currently, there can be different bases of valuation (loss of profits, bidding costs incurred, some element of opportunity cost etc.).

The Commission has also recently attempted<sup>152</sup> to clarify the rules relating to certain types of transaction which are not fully regulated by the Public Procurement Directives. This covers Part B services but not concessions, because the need for a legislative initiative on concessions is the subject of the impact study currently in progress.

The Commission's Interpretative Communication provides guidance to Contracting Authorities to help them comply with the standards developed by the ECJ, in particular in the following areas:

- Advertising, where it explains how to ensure that contracts are advertised adequately and transparently. It gives specific guidance on how widely the contract should be advertised, various methods of advertising that could be used, and which elements the advertisement should contain
- Contract award, where it provides guidance on how public authorities can ensure a fair and impartial procedure for awarding a contract. The principles of such a procedure include a transparent and objective approach, appropriate time limits, mutual recognition between different Member States, equal access for economic operators from all Member States, and non-discriminatory description of the subject matter of the contract
- Review procedures, where the Communication explains how bidders can request a review of the impartiality of decisions taken in the course of an award procedure.

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<sup>152</sup> In an Interpretative Communication issued in August 2006, *Community law applicable to contract awards not or only partly regulated by the Public Procurement Directives*. The issue of re-classification of services is not, of course, dealt with in the Interpretative Communication.

## COMPETITIVE DIALOGUE – THE LEGAL REQUIREMENTS

The previous Public Procurement Directives offered two possible award procedures for PPP i.e. the restricted procedure and the negotiated procedure with and without publication of a contract notice. The latest Public Procurement Directive retains these procedures but also introduced a new contract award procedure known as Competitive Dialogue,<sup>153</sup> designed to make the use of PPP easier.

Art 1(11)(c) defines Competitive Dialogue as “a procedure in which any economic operator may request to participate and whereby the Contracting Authority conducts a dialogue with the candidates admitted to that procedure, with the aim of developing one or more suitable alternatives capable of meeting its requirements, and on the basis of which the candidates chosen are invited to tender”.

Competitive Dialogue is meant to allow a public entity which knows what outcome it wants to achieve but does not know how best to achieve it to discuss, in confidence, possible solutions in the dialogue phase of the tender process with short listed bidders before calling for final bids. This is likely to be the case for many PPP and so the use of the restricted procedure to award them is likely to be less common than the use of Competitive Dialogue.

Competitive Dialogue is intended to be used more frequently and be easier to justify than the negotiated procedure in the former Public Procurement Directives, the procedure used for complex contracts in the past.<sup>154</sup> It will be able to be used for “particularly complex contracts” where a *Contracting Authority considers*<sup>155</sup> that use of the open or restricted procedures (requiring pre-determined specifications) will not allow the award of the contract. Directive 2004/18 envisages (at Recital 31) that the Competitive Dialogue procedure could, for example, be used to award contracts for integrated transport infrastructure projects or large IT projects or with complex financial and legal structures which cannot be determined in advance of the

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<sup>153</sup> See Art 29, Directive 2004/18. Here the reference is specifically to the Public Contracts Directive, since the option to use the Competitive Dialogue is not included in the Utilities Directive (and is not needed there because in awarding contracts under Directive 2004/17/EC Contracting Entities are not required to justify the use of the negotiated procedure).

<sup>154</sup> This is clear from the Commission’s Explanatory Note on Competitive Dialogue of January 2006, which, at Section 2.1, describes the procedure as a “special procedure, whose use is regulated” and not, as is the case with the negotiated procedure, an exceptional procedure. The contrast between the justification for, and expected extent of use of, the two procedures is also explained in *the PPP Green Paper*, pp. 8-9.

<sup>155</sup> Author’s emphasis, taken from the Directive.



tender process.

The Competitive Dialogue procedure is in effect a hybrid between the negotiated procedure and the restricted tender procedure, in which there needs to be a clear three stage structure to the award of complex contract. This has not always been the case in the past when the negotiated procedure has been used.

The stages in the Competitive Dialogue procedure are:

- A short listing phase, in which suitable tenderers are selected who meet the minimum eligibility standards for financial, economic and technical criteria. This is the only part of the process for which timescales are specified i.e. 37 days, with a reduction permitted where electronic means are used to draw up and transmit contract notices to OJEU
- A dialogue phase with tenderers where alternative solutions are discussed and negotiation is permitted. This phase, in which the Contracting Authority meets with the short listed suppliers to identify and define solutions to meet the need, is crucial to the successful application of the Competitive Dialogue procedure
- A final tender phase with the submission of tenders after which fine tuning, further specification and clarification are permitted provided that they do not change the basic features of the tenders or the contract's key terms. Further clarification of the winning tender and/or confirmation of commitments in it can then be sought if required.

In the negotiated procedure there is no obligation after short listing for the process to follow any particular structure for the negotiations.<sup>156</sup> Though many public entities in practice did set out a clear structure and timetable in advance and fixed the key elements of the specification and contract conditions in a competitive environment, in the Competitive Dialogue procedure the need is now clearer because of the restrictions on negotiations after the final tender is submitted. The use of the Competitive Dialogue procedure could thus have the effect of underpinning existing good practice in PPP i.e. that selection of preferred bidder should not happen until all substantial terms and conditions affecting the price and delivery of the scheme have been settled while there is still competition.

The main legal requirements of the Competitive Dialogue procedure are that:

- Though intended to be easier to justify than the negotiated procedure the use of the Competitive Dialogue procedure must still be objectively jus-

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<sup>156</sup> Though there is, of course, an obligation to comply with the principles of transparency, equality of treatment and non-discrimination in the negotiations.

tified i.e. it can be used when, in addition to the assessment of the Contracting Authority that the use of the open and restricted procedure will not allow the award of the contract:

- The Contracting Authority is not objectively able to define the technical means capable of satisfying their needs or objectives, and/or
- The Contracting Authority is not objectively able to specify the legal and/or financial make-up of a project.

The concept of objective impossibility is qualified in the Directive<sup>157</sup> as being circumstances when this occurs but “*without this being due to any fault on their part*” i.e. on the part of the Contracting Authority

- The Contracting Authority can only use “most economically advantageous tender” award basis
- The process is launched by publication of a contract notice. This must state the minimum capacity levels needed to be invited to participate in the dialogue phase
- Either the contract notice and/or the descriptive document must set out the needs and requirements of the Contracting Authority
- The number of candidates to be selected for the dialogue phase must be indicated in the contract notice. There must be at least three candidates selected for the dialogue phase, assuming that at least three meet the minimum capability requirements. There is an overriding test that the number selected must be sufficient to provide genuine competition<sup>158</sup>
- The award criteria, either weighted, or, in certain circumstances (which require specific justification) in descending order of importance, should appear in the contract notice or in the descriptive document and may not be changed during the award procedure
- The dialogue may be conducted in successive stages. Those unable to meet the need or provide value for money (as measured against the published award criteria) may be eliminated at each stage
- If a Contracting Authority intends to gradually reduce the number of solutions during dialogue phase, this should be indicated in the contract notice or the descriptive document
- All candidates and tenderers must be treated equally and commercial confidentiality must be maintained unless the candidate agrees that information may be passed to others
- The Contracting Authority is required to declare that the dialogue phase is over and to tell the participants
- Contracting Authorities will ask them to submit their final tenders on the

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<sup>157</sup> Recital 31, Directive 2004/18.

<sup>158</sup> Art 44(3), Directive 2004/18.

basis of the solution or solutions presented and specified during the dialogue

- The final tenders submitted must contain all the elements required and necessary for the performance of the project
- Once the final tenders have been received, the Contracting Authority is permitted to ask the bidders to “clarify”, “specify” and “fine tune” tenders but not change their basic features
- The final tenders are assessed against the criteria stated in the contract notice or the descriptive document
- The Contracting Authority is permitted to ask the bidders “clarify aspects of the (winning) tender and “confirm commitments contained in the (winning) tender”
- Contracting Authorities may, but are not obliged to, specify that payments are to be made to participants in the dialogue.<sup>159</sup>

There are two key issues here for public authorities to consider.

Firstly, the European Commission considers<sup>160</sup> that the Competitive Dialogue procedure, clearly giving public bodies the freedom to negotiate the technical, legal and financial aspects of public contracts, is particularly well adapted to PPP and will provide the necessary legal certainty so important to confidence in long term PPP-type contracts. This contrasts with the narrower view taken by the Commission about the permissible uses of the negotiated procedure i.e. that it applies principally to technical aspects of the contract and not, strictly, to legal and financial aspects.<sup>161</sup> Having reaffirmed this narrower view, albeit one never universally shared by Member States, and having made available the Competitive Dialogue procedure, it is reasonable to assume that the Commission may now seek to enforce this interpretation by a greater readiness to challenge what it considers to be the inappropriate use of the negotiated procedure.

Secondly, in spite of the Commission’s Explanatory Note on the application of the Competitive Dialogue procedure there are significant areas of

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<sup>159</sup> There may be circumstances in which a Contracting Authority may wish to make a retainer payment to the second placed bidder for a strictly limited period of time if they judge it necessary to retain a reserve option while the contract with the winning bidder is being finalised, thereby maintaining some competitive pressure on the winning tenderer. This, of course, is not necessary if substantially all of the key contractual issues have been resolved prior to the submission of tenders. Subject to this very limited exception, payments to losing bidders are likely to be very difficult to justify (to auditors, amongst others) on value for money grounds.

<sup>160</sup> *The PPP Green Paper*, p. 10.

<sup>161</sup> *Ibid*, p. 9.

legal uncertainty about how the procedure can be implemented in practice.

It will be necessary for public authorities to demonstrate that the use of the procedure has been properly justified i.e. that the transaction is a “particularly complex” contract and that it cannot objectively determine how its needs can be satisfied.

This will, at minimum, involve the Contracting Authority in a process of:

- Identifying the uncertainties which it cannot resolve without the Competitive Dialogue procedure<sup>162</sup>
- Ensuring that it has followed a process of attempting to determine how its needs can be satisfied without using the Competitive Dialogue procedure. In some cases, networks with other Contracting Authorities, market research, including dialogue with suppliers, and/or the assistance of third party consultancy expertise may lead the Contracting Authority to be able to substantially determine its needs prior to the start of the procurement process. Clearly, this is more likely in mature markets and sectors where PPP have been used previously in similar schemes<sup>163</sup>
- Documenting the decision such that it can be explained if challenged by third parties or questioned by auditors
- Obtaining a robust legal opinion to support the decision.

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<sup>162</sup> These could include, for example, matters such as possible alternative solutions, how much demand risk the supplier is prepared to accept, how the availability payment is to be calculated from its individual components (e.g. different rooms/blocks in a school or hospital) as well as any of the contents of the service specification and contract conditions.

<sup>163</sup> There is a possible paradox here, the outcome of which is yet to be resolved, which is that the more effort a Contracting Authority makes, and the more experience it has, the more difficult it may become to justify the use of the Competitive Dialogue procedure. The qualifications to the use of Competitive Dialogue in Recital 31 rest on the assumption that, even if the Contracting Authority is fairly certain about the outcome it wants, dialogue would not be beneficial with the participants. The author’s experience is that a Contracting Authority will stay more effectively in control of the award process if it is substantially clear before its launch about the likely achievable outcomes, the optimal allocation of risks, the strengths and weaknesses of the technical solutions likely to be proposed and the approximate cost. If so, the dialogue phase can be based on the marking up (proposed amendments to/comments on) by participants of the Contracting Authority’s preferred solution (or solutions if it chooses). This is not of course the only way the dialogue phase can be conducted. But it would be perverse if Contracting Authorities which choose to conduct it in this way were to be at risk of legal challenge. The nature of the dialogue with the participants may in any case vary according to the current state of the market and/or the particular concerns of the participants actually in the dialogue, so the nature of the amendments proposed and which the Contracting Authority may accept cannot in general be objectively foreseen.

In practice, however, the greater risk of legal challenge (initiated by those dissatisfied with the outcome of the process) lies in the way that the procedure is implemented both the dialogue phase and the post tender phase. These will require a high level of care needed to manage the process (and thus be very time consuming for public authorities).

The main issues derive from:

- The concerns of suppliers<sup>164</sup> about whether in reality the confidentiality of bids enshrined in the Public Procurement Directive will actually be protected in the dialogue phase of the process and how the dialogue phase of the process will be conducted in a manner consistent with the principles of equal treatment, non-discrimination and transparency, especially if there is more than one stage to the dialogue
- How in practice the process will be conducted after the submission of final tenders. Will there still be pressure to accommodate the needs of lenders, which often lead to significant changes to projects at a late stage, i.e. after the selection of the most economically advantageous tender when negotiations are not permitted? This could lead in practice to public authorities seeking to stretch the limit of the meaning of clarification of tenders or confirmation of commitments included in the tender, both of which the Public Procurement Directive does permit.

To reduce the risk of legal challenge Contracting Authorities will thus need to address issues specific to the Competitive Dialogue procedure. This is in addition to the decisions which Contracting Authorities need to make in procurement processes using any other procedures, such as determining information to be given to those who express an interest in the contract, the selection criteria, the number to be short listed, the award criteria and their weighting and the form in which responses will be required in submitting expressions of interest and tenders, how selection and award decisions will be made, and compliance with the standstill requirements deriving from the *Alcatel Austria* decision<sup>165</sup> etc.

These will include determining:

- The role and content of the descriptive document<sup>166</sup>
- The number of stages in the dialogue phase<sup>167</sup>
- The timetable for dialogue phase/interim stages of the dialogue phase
- The objectives of different stages of the dialogue phase e.g. whether or not it will be used to move from outline to detailed solutions, to refine the

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<sup>164</sup> As, for example, expressed in various responses to the Commission's consultation on the PPP Green Paper.

<sup>165</sup> ECJ case C-81/98.

preferred solution(s) of the Contracting Authority, as a means of consecutively assessing technical solutions and then financial offers, whether or not bidders will be eliminated in interim phases and if so how, how issues will be closed off etc.<sup>166</sup>

- The methods to be used in the dialogue phase e.g. written submissions, one to one discussions, presentations etc.
- The form in which responses will be required in submitting interim solutions e.g. the degree of conditionality acceptable in interim solutions, whether or not interim pricing (“offers”) should be requested, the number of solutions a bidder can offer etc.
- The means by which equality of treatment between bidders can be ensured in the dialogue phase, and in particular the timetable and structure for information flows between bidders and the Contracting Authority and the frequency, scope, conduct, recording of meetings etc.
- The means by which the confidentiality requirements of the law can be respected in the dialogue phase, including, in particular, how what is confidential and non-confidential data can clearly identified, how the confidentiality of confidential data will be preserved (transmission, storage, access etc.) and the extent to which the Contracting Authority can encourage those who express interest and/or participants in the dialogue phase to minimise the information which is deemed to be confidential etc.
- When the Contracting Authority will conclude the dialogue phase, bearing in mind it is necessary to specifically declare that the dialogue phase has been concluded
- How the Contracting Authority should call for final tenders i.e. in what form
- How much time the Contracting Authority should allow for final tenders to be submitted
- How many final tenders the Contracting Authority should call for after

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<sup>166</sup> At this stage of the award procedure (the start of the dialogue phase) the Contracting Authority will have eliminated those candidates with which it is not prepared to contract. It should therefore bear in mind throughout the dialogue and tender phase that the overall objective is to receive unconditional offers which are capable of meeting its service need throughout the life of the contract and which comply with the administrative requirements of the award process. In the author’s experience the best way to do this is to provide short listed organisations with the fullest possible access to the information necessary to be able to submit such offers (and, subject to a controlled process, to key people able to elaborate on that information if needed). It is good practice, for example, to create an electronic data room in a secure environment which bidders can access. The same prejudice in favour of providing as full a reply as possible should also extend to requests for further information and clarification by bidders, subject to the need to maintain strict equality between bidders.

- the conclusion of the dialogue phase
- What, after tenders have been received, do the terms in the Directive “clarify”, “specify” and “fine tune” tenders allow the Contracting Authority to do in practice<sup>169</sup>
  - What constitutes a “change to a basic feature of a tender”<sup>170</sup>
  - What “clarify aspects of tender” and “confirm commitments in (winning) tender” mean in practice<sup>171,172</sup>
  - The means by which equality of treatment between bidders can be ensured in the post-tender phase i.e. that:
    - Equal opportunities are given to “clarify”,<sup>173</sup> “specify” and “fine tune” tenders
    - Once the winning tender has been selected, the process of “clarifying aspects of tender” and “confirming commitments in (winning) tender” does not offer opportunities to the winning tenderer of such a significance that, had they been offered to other tenderers, it might have changed the result of the tender process
  - The means by which the Contracting Authority will ensure that the contract awarded is sufficiently similar to the opportunity advertised. This is not specific to the Competitive Dialogue procedure, but is particularly relevant to procurements conducted using it, given the extent to which the process is likely to involve negotiation about how desired outcomes of the Contracting Authority may be met<sup>174</sup>
  - How the Contracting Authority will confirm that the final contract con-

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<sup>167</sup> Definition of the parameters for the dialogue phase – number of stages, timetable, objectives, methods – is a crucial decision for the Contracting Authority. As is clear from note 163 above, there are two types of approach which can be followed i.e. the investigative approach, where the Contracting Authority seeks to explore most of the elements of the solution, which is likely to be bidder driven and the consultative approach, where the bidders comment on an a public sector driven preferred solution. The latter approach is more likely to enable the Contracting Authority to stay in control of the process. Thus in a sense it is contended that the Competitive Dialogue procedure could be regarded as being closer to a flexible form of the restricted procedure rather than as a structured form of the negotiated procedure. There is of course no intent in this to constrain innovation in the design and delivery of the project but it is intended to ensure that as far as possible the Contracting Authority is able to maximise the amount of that innovation before the start of the award process.

<sup>168</sup> Another approach to the dialogue phase could be to use the first stage to develop a hybrid solution i.e. one based on the best features of the solutions proposed by the different participants. This, of course, would require their agreement in the light of the confidentiality provisions in Directive 2004/18.

<sup>169</sup> See Art 29(6) Directive 2004/18.

<sup>170</sup> *Ibid.*

<sup>171</sup> See Art 29(7) Directive 2004/18.

tinues to represent value for money as compared to other procurement routes

- How these matters will be communicated within the Contracting Authority e.g. by internal guidance notes prepared prior to the relevant stages of the process and a code of conduct
- How, to ensure transparency, participants in the process will be made aware of the above, for example by sharing appropriate parts of the code of conduct with them.

To date, because of the recent introduction of Competitive Dialogue as an award procedure, and thus limited practical experience of its implementation, there has so far been no ECJ case relevant to its (mis)application. But, given the many points of interpretation needed, the current trend of increasing litigation, the wider introduction of Freedom of Information legislation in EU Member States, the value of the contracts at stake and the recent proposal for revisions to the Remedies Directives for a standstill period between contract award and contract signature,<sup>175</sup> a public authority would be very unwise to assume that such cases will not arise.

## **PPP AFTER THE SELECTION OF THE PRIVATE PARTNER**

There is one specific area of possible legal uncertainty during the contract execution phase i.e. the extent to which changes can be made to the scope or terms of PPP contracts during their execution in a manner consistent with Community law. This is particularly relevant to PPP, because of the long term nature of the contracts which they involve.

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<sup>172</sup> The author is familiar with the argument that the optimal outcome in practice of the implementation of Competitive Dialogue would be to re-introduce the same kind of wide scope for post-tender negotiation which occurred under the negotiated procedure so that, for example, matters such as the price, scope of the performance regime, detailed building design, detailed planning permission, the precise terms of the financing of the transaction and other key contract conditions would be determined only after the selection of the winning tenderer (often referred to as the “preferred bidder” in the negotiated procedure). But the advocates of such a view are under an obligation, as well as addressing the legality of such an approach, to explain the commercial logic of an approach to a transaction which leaves these key areas to be determined when there is no competition. The Commission’s Explanatory Note on Competitive Dialogue (at Section 3.3) makes it clear that the intention is not to allow negotiations with the winning tenderer.

<sup>173</sup> The term “clarification” in the context of the open and restricted procedure has generally been taken to have a restrictive meaning and to exclude negotiations with candidates on fundamental aspects of contracts, according to a Council of Ministers’ statement issued in 1989 (OJ L210, 21 July 1989).



The Public Procurement Directives primarily refer only to the selection phase of a PPP and not to the period of the execution of the contract.<sup>176</sup>

There is an evolving body of case law relevant to the partner selection phase, i.e. matters arising in the selection process up to the point of the award of the contract. Some of these cases are referred to in the PPP Green Paper<sup>177</sup>, albeit rather confusingly, since they appear in a section described as relating to the period after the private partner has been selected. The continuing relevance of this case law has recently been reinforced by the action taken by the Commission against Spain for the award of a motorway works concession (the A6 motorway), where the concession awarded included an additional package of works not referred to in the concession notice or the tender documents.

The preponderance of cases relevant to the selection process is as might be expected, given the difficulties for third parties in gaining information about the execution of the contract and the shift in the balance of advantage for a losing bidder once the contract has been awarded. The time, cost and uncertainty of outcome of bringing a case and the likelihood of obtaining only damages, which may be the only remedy available if an EU Member State has availed itself of the option<sup>178</sup> to restrict remedies to damages after the award of the contract, are real barriers to taking legal action. In practice, after the award of the contract participants are likely to focus on the next available opportunity so that changes during execution are less likely to be

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<sup>174</sup> In the author's experience, suppliers may also use the dialogue process to seek to change the desired outcomes, for example on grounds of technical infeasibility, cost or unwillingness on their part to accept risk. If this happens, it may raise similar legal questions i.e. about the freedom to provide services and transparency. Even if it did not raise such questions, any such significant changes reflect badly on the planning of the Contracting Authority and reflect a loss of control of the process by them. Hence the advisability of a commitment within the public entity, no later than the completion of the first phase of the process (short listing) and before the second phase (dialogue), to invest time and resources in understanding the potential solutions likely to be proposed by the bidders in the dialogue, an assessment of the strengths and weaknesses of those potential solutions, clear outcomes and performance standards for those solutions and a clear idea of what would encourage and deter bidders to submit bids offering the best value for money.

<sup>175</sup> See *Proposal for a Directive of the European Parliament and of the Council amending Council Directives 89/665/EEC and 92/13/EEC with regard to improving the effectiveness of review procedures concerning the award of public contracts*, European Commission, COM (2006) 195, May 2006, Art 2. As noted above, this proposal derives from what is widely regarded as settled ECJ case law (*Alcatel Austria* C-81/98 and *Commission v Austria* C-212/02) and is thus already relevant to contract awards. It remains a point of debate amongst legal commentators about precisely when, in a Competitive Dialogue procedure, the standstill period should be invoked. For an explanation of the issues see Adrian Brown, "Applying Alcatel in the context of Competitive Dialogue", *Public Procurement Law Review*, Sweet and Maxwell, Issue 6, 2006, p. 332 *et seq.*

identified in the absence of a national PPP supervisory body or the active engagement of auditors.

More cases in respect of the selection procedure may also reasonably be expected in future in respect of challenges to the selection procedure (and particularly in high value contracts such as PPP) given the reform to the Public Procurement Remedies Directives proposed by the Commission in May 2006.

But the nature of PPP, which are long term and often complex contracts, and thus potentially subject to change during the life of the contract, is such that issues may arise in the contract execution phase which call into question how Treaty principles should be applied to them. This is not surprising, since it is an extension of the logic which led to the formulation of secondary legislation for public procurement in the first place i.e. that Treaty principles did not provide sufficient clarity for Contracting Authorities to determine how to conduct public procurement award procedures.

The PPP Green Paper refers to the contract execution phase in five respects.

Firstly, it recognises (at p. 15) that “since they concern a service spread out in time, PPP relationships must be able to evolve in line with changes in the macro-economic or technological environment in line with general interest requirements” and notes that “in general, Community public contract law does not reject such a possibility, as long as this is done in compliance with the principles of equality of treatment and transparency”.

The PPP Green Paper then draws a distinction between situations when the contract documents envisage change during its execution and when they do not. Only a very narrow set of circumstances (i.e. on public policy, public security and public health grounds), or necessity on the grounds of unforeseen circumstances, are defined as being permissible causes of change without the launch of a new award procedure if such change is not envisaged in the contract documents. It then refers to the fact that, in addition, any substantial modification relating to the actual subject matter of the contract must

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<sup>176</sup> It is clear (see, for example, Art 26, Directive 2004/18) that a Contracting Authority may set out performance conditions for the execution of the contract provided that “these are compatible with Community law and are indicated in the contract notice or in the specifications”. But these are a matter of compliance with Community law in the partner selection phase and not, *per se*, with changes to such conditions in the execution phase or non-compliance with them in executing the contract.

<sup>177</sup> See ECJ cases such as Case C-87/94, *Commission v. Belgique (Bus Wallons)*, Case C-243/89, *Commission v. Denmark (Bridge on the Storebaelt)*, Case C-31/87, *Gebroeders Beentjes v. Pays-Bas* and Case C-337/98, *Commission v. France*.

<sup>178</sup> See Art 2, Remedies Directive.

be considered equivalent to the conclusion of a new contract, requiring a new competition.

Thirdly, the PPP Green Paper refers to the exercise of step-in rights by lenders i.e. where they intervene during the execution of the contract to replace the main service provider. The issue raised by the Commission is whether or not the replacement of a failing service provider without competition raises questions about the principle of transparency and of the freedom to provide services.

Fourthly, it also refers to the fact that the use of sub-contractors during the execution of a PPP may be subject to the Public Procurement Directives. This will often be the case if the service provider is itself a Contracting Authority.<sup>179</sup> In the more usual situation that the service provider is not in the role of Contracting Authority, it is in principle generally free to conclude contracts with third parties, whether these be its own shareholders or not.<sup>180</sup>

Finally, the PPP Green Paper refers to one matter which must be considered equivalent to awarding a new contract to the same concessionaire i.e. the extension of an existing concession beyond the period originally laid down. This emphasises that the provisions of Art 31 of the Public Procurement Directives relevant to the procurement of additional works and services must be interpreted restrictively.

But there is much more complexity in the applicability of EU law to the contract execution phase than is admitted by the PPP Green Paper, and it is possible to draw on a number of other possible sources of evidence for an assessment of whether or not there exists sufficient clarity and thus legal certainty about what changes are and are not permissible in the contract execution phase.

Firstly, the issue of change to the contract during execution may also be informed by the question of opening of share capital of publicly owned enterprises which deliver services, one of the ways in which (as the Commission identified in the PPP Green Paper) that an IPPP can be created.

In the *Stadt Mödling* case (*Commission v Austria*<sup>181</sup>) the ECJ ruled that the separation of the award of a long-term public services contract to a publicly owned enterprise and the disposal of a significant minority of the share

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<sup>179</sup> Except where the services entrusted by the service provider to its shareholders have already been the subject of a competition by the public partner prior to the formation of the company undertaking the project. See PPP Green Paper, p. 17.

<sup>180</sup> This will not apply when the project company is a “works concessionaire”, when certain publicity requirements apply to the award of works contracts exceeding a threshold of EUR 5 million, with the exception of contracts concluded with businesses that have formed a group in order to win the concession, or their affiliated companies, *ibid.*

<sup>181</sup> C-29/04.

capital of the enterprise to a private partner represented a deliberate attempt to circumvent the provisions of the Public Procurement Directives. In the particular facts of the case the artificial nature of the sequence of transactions was clear. But the same considerations could arguably be said to arise even if there was a significant time gap between the award of the contract and the opening up of the share capital of the enterprise i.e. it could represent a significant modification to the contract, thus requiring the launch of a new award procedure. This follows the logic of the *Stadt Halle* case<sup>182</sup> that the opening up of the share capital changes the nature of the entity delivering the service and thus creates a contract where none previously existed in EC law. This matter may be addressed in the Commission’s forthcoming Interpretative Communication on IPPP.

Secondly, the extent to which any changes to the terms of the contract, particularly those which make them overall more favourable to private partner, then render the payments made under the contract a breach of state aid rules. One view is that a change which does not make the terms overall more favourable to the private partner will not be state aid and that, even if the changes do make the terms more favourable overall, it may not be state aid if the Contracting Authority acts like a private entity would have behaved in pursuing its commercial interests.<sup>183</sup> This is, however, problematic in the sense of not providing legal certainty, since it is a characteristic of PPP that, because of the relative weakness the Contracting Authority in managing variations to a PPP arising from the absence of competition once the private partner has been selected, in most cases the terms will become less favourable to the public sector.<sup>184</sup> The Contracting Authority is then left to interpret the case law on the market investor test.

Thirdly, in addition to the extension of an existing contract, which is referred to in the PPP Green Paper as an example of contract change requiring re-tendering, there is the question of the extent to which other means of procurement of additional works and services without competition would represent a substantial modification of the contract. These are permitted in

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<sup>182</sup> C-26/03.

<sup>183</sup> See Sue Arrowsmith, *The Law of Public and Utilities Procurement*, Sweet and Maxwell, 2005, p. 228. The analysis cited here primarily rests on the outcome of the Commission’s investigation into the London Underground PPP (Case N264/2002, London Underground Public-Private Partnership, European Commission, Decision of October 2, 2002), which related to changes to the contract arising from negotiations with the preferred bidder and prior to signature, rather than to matters arising in the execution of the contract. As noted above, the Commission examined the financial arrangements for the London Underground PPP in some detail to assess whether or not there was a cause for action before finally determining that there was not.

what, as noted above, are intended to be narrowly defined circumstances in Article 31, Directive 2004/18, but which, in reality, still need further clarification, for example of what might constitute “unforeseen circumstances”, “major inconvenience” and/or “strict necessity”.<sup>185</sup>

The other material considerations which need to be taken into account in assessing the extent to which clarity currently exists or is likely to be improved in future are:

- The absence of current legislative proposals by the Commission at Community level for the contract execution phase, since, as noted above, the Commission concluded, in the PPP Communication, that as a result of the consultation no further legislative action was to be proposed at this stage.<sup>186</sup>
- The relative paucity of specific ECJ case law<sup>187</sup> about the question of permissible changes to PPP contracts during the execution phase
- The uncertainty about the extent to which any of the principles used in deciding cases relevant to the partner selection phase would be applied by the ECJ in any cases specific to the contract execution phase
- The existence of different provisions in national law relevant to contract change, whose existence, and/or their interpretation by national courts, could be a barrier to service providers seeking to operate cross-border.<sup>188</sup>

Thus it is submitted that, taken together, these elements lead to insufficient clarity in Community law for Contracting Authorities about what is

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<sup>184</sup> The orientation here is the maintenance of value for money for the public sector, though, of course, the author recognises that there can be circumstances in which imposed changes may cause difficulties for the service provider. In privately financed PPP, however, these are not likely to be accepted by lenders. More generally, the contention that the public sector’s position is one of weakness rests on the fact that, in many cases, the service being provided in the PPP is one for which the public sector cannot accept a service interruption and is not necessarily likely to easily be able to find an alternative service provider in the event that a dispute leads to a cessation of service provision, especially if there is evidence that this dispute has arisen because of the unreasonable behaviour of the Contracting Authority.

<sup>185</sup> If the additional services are unnecessary, they might represent state aid. See David O’Keeffe, “Public Private Partnerships, Local Authorities and State Aid”, *European PPP Law Review*, Lexxion Verlagsgesellschaft, Issue 1, 2007, p. 19.

<sup>186</sup> *The PPP Communication*, p. 5.

<sup>187</sup> It should be noted here, however, that the Commission itself was the subject of an ECJ judgement which challenged its own conduct in the execution of a contract in which the means of payment were changed in a way which had not been foreseen in the tender documents. See Case C-496/99 – *CAS Succhi di Frutta SpA v the Commission*. This complex case, which related to the supply of processed food products to Armenia and Azerbaijan, partly turned on the Commission’s claim that unforeseen circumstances led it to change the means of payment.

and is not permitted during the contract execution phase.

The author’s view is that it would be of significant value if the Commission were to attempt to define what constitutes permissible change through the publication of an explanatory note. A recent precedent relevant to PPP exists for this approach with the publication by the Commission in January 2006 of an explanatory note on the application of the Competitive Dialogue procedure in the public contracts sector.<sup>189</sup>

What issues could such an explanatory note address?

In addition to the potential for clarification in respect of the opening up of share capital and state aid issues, it could, for example, consider refinancing arrangements (where the original debt incurred by the private partners is replaced by secondary debt on more favourable terms) or changes of ownership of the private partner (by take-over or merger of one of the members of the supplier consortium, changes in the structure of a supplier consortium or sale by a shareholder of its stake in the PPP). In what circumstances could they be said to be necessary due to unforeseen circumstances or can they be justified on the grounds of public policy, public security and public health? When do they represent substantial modifications to the subject matter of the contract which are not permissible without re-tendering on the grounds that they may impact upon equality of treatment between tenderers?<sup>190</sup>

Changes in the ownership of equity capital of the private partner are particularly problematic given that the Contracting Authority will have based its decision to short list a bidder on the basis of qualification criteria and then, when awarding the contract, taken account of the appropriateness and sustainability of its offer. Integral to this is the overall management of the construction of the asset and the delivery of the service by the lead members of the consortium. Thus the Contracting Authority cannot be neutral about

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<sup>188</sup> Examples of the different approaches in national law can be found in Vito Auricchio, “The problem of discrimination and anti-competitive behaviour in the execution phase of public contracts”, *Public Procurement Law Review*, Sweet and Maxwell, Issue 5, 1998, p. 113 *et seq.*

<sup>189</sup> In advocating this approach, the author is of course aware of the risk that any consultation on such a note could represent a replay of the outcome of the stakeholder consultation on the PPP Green Paper. But this does not undermine the force of the case for such an explanatory note, and is rather a comment on the limitations of stakeholder consultation.

<sup>190</sup> It is worth noting here that, irrespective of any legal issues at stake, these developments have major relevance to value for money for the public sector. This is clear from the well publicised UK cases, such as the refinancing of the Darent Valley and Norfolk and Norwich hospital PFI schemes noted above, where refinancing led to very significant increases in the returns for equity investors as compared to those envisaged at the time of contract award.

changes in ownership of stakes. Put simply, change in the ownership of the entity changes the basis of the decision made by the Contracting Authority, may impact on how the service is delivered and potentially undermines the synergy of PPP i.e. that the best way to optimise the efficiency of design, construction, operation and maintenance of the asset is if the private partner responsible for design and construction of the asset is then required to operate and maintain it for a fixed price.

The explanatory note could also (non-exhaustively) define how the tests set out in the PPP Green Paper could be applied to changes which may be significant in respect of the price paid, the scope of the contract (which may include reduction), the timetable for the execution of the contract (which may mean acceleration or delay) or the allocation of the risks to the private partner, even if there is no overall increase in the value of risks transferred.

Other areas which may or may not represent substantial modifications, and thus would benefit from clarification in an explanatory note, include changes in performance indicators or targets for them, changes in the way the performance management regime is conducted, changes in contract conditions, changes in execution procedures,<sup>191</sup> the circumstances in which step in by lenders is permissible and changes in the payment or tariff regime.

This analysis is not intended to prejudge the extent to which all or any of these events represent change during the execution of the contract sufficient to constitute a new contract<sup>192</sup> or whether there is a concept of there being “essential terms” of a contract.<sup>193</sup> It merely argues that further clarification of Community law would be desirable in the interest of promoting legal certainty.<sup>194</sup> It could, for example, be the case that the extent of change which should be permitted may vary according to the risk being assumed by the private partner i.e. in a financially free standing PPP, where the service provider is taking all or most of the demand risk, more flexibility in a legal sense should be permitted in the nature of the services provided, means of provision and the tariff regime etc.

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<sup>191</sup> This may include replacement of sub-contractors where these have been an explicit part of the selection decision in the sense that the main service provider relied on them

<sup>192</sup> Arrowsmith, *op cit*, p. 287 *et seq*, Auricchio, *op cit*, Lasok and Bowsher, (see respectively notes 193 and 195 below), *inter alia*, refer to a number of guiding principles which might be used to inform any such clarification by the Commission. The fact that there are differences in national law in respect of permissible changes may provide a number of options which might well be used by the Commission to define a Community framework

<sup>193</sup> For a discussion of this concept, see Paul Lasok, “Changing the Contract Specification during and after the tender process”, Monckton Chambers, January 2003.

<sup>194</sup> Some of these issues are currently being considered the ECJ in the *Pressetext* case (C-454/06).

Such clarity is particularly important if the scope of the legal framework for public procurement is considered in its wider context. Even though, after the consultation launched by the PPP Green Paper the Commission concluded that there was no need for Community legislative action to deal with the contract execution phase, this does not mean that there will be no evolution and definition of the legal framework for PPP. In practice, it may lead to the Community legal framework in the contract execution phase being developed by cases decided in the ECJ. There will be those who argue that such a development would be desirable. But the author is firmly of the conviction that in the interests of legal certainty, which is so important to PPP, that as much as possible of the legal framework should be determined by legislators and the executive. If the legal framework is not determined by legislators and the executive, then it will be determined by the judiciary, with, it is submitted, the negative consequence for long term contracts such as PPP, that the supposed benefits of flexibility will be outweighed by the uncertainty deriving from the evolution of law through decisions in individual cases.

The use of an explanatory note to define best practice is a step towards what has been referred to as “positive, principled law making” even though its effect would be purely declaratory.<sup>195</sup> It is recognised that this approach may be seen as differing from the principle underpinning what may be termed the “economic interest” approach to public procurement i.e. that the pursuit of breaches of public procurement rules are for those who are or might be harmed by such breaches (the essence of the approach in the Remedies Directive). But it has the advantage of flexibility and breadth of coverage in that it can address a wider range of issues than may arise from an individual action. It would also give technical guidance on what might be regarded as best practice, from which Contracting Authorities would be required to justify derogations. It would also not create the immediate prospect of a demand for additional resources for the Commission, which an alternative approach of pro-active investigation of contracts in execution would require of them.

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<sup>195</sup> See Michael Bowsher, “EU Procurement: The Regulation of Negotiations, Changes and Extensions of Contracts”, Monckton Chambers, March 2002.





## CHAPTER 5

# PPP – The Operational Framework for Public Authorities

### OVERVIEW

Prior to entering into a PPP a public authority needs to go through a process of making a conscious choice to use the PPP route for delivering a public service. It cannot be emphasised too readily that PPP are only one form of public service delivery, which should be justified on a case by case basis as delivering benefits over and above alternatives.

This involves five key elements i.e.

- The public authority must have clear and measurable corporate and service delivery objectives which it wants to achieve<sup>196</sup>
- There must be a viable way of achieving those objectives i.e. there must be a project which is affordable over its life, brings clear economic and/or financial benefits, is sustainable in technical and environmental terms and does not involve unacceptable risks to the public sector (which may include fiscal and market management risks relating to the management of overall public service investment and the retention of public policy choice)
- PPP must represent a better option for whole life value for money than the alternatives i.e. than public service delivery and other forms of third party contract, bearing in mind that a privately financed PPP may be the only way of realising the project
- The private sector partner must be able to make a profit commensurate with the risks which it is accepting
- Lenders should be assured that, if their borrower, the private sector partner, fulfils its contractual objectives, their loan will be repaid.

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<sup>196</sup> It is a given that these can include a mix of commercial and non-commercial objectives, which may include social and environmental objectives. These are not, of course, excluded from the scope of objectives of a PPP, provided that, as with all other forms of public procurement, they are pursued in accordance with Treaty principles and the Public Procurement Directives.

Having established that a PPP is the appropriate route for a project, it is then necessary to ensure that it is planned and procured effectively and then managed in such a way as to ensure that the value for money achieved in the procurement process is realised in the execution of the contract. The importance of devoting sufficient time to planning a PPP before the commencement of the procurement process and sufficient skilled resources and time to the management of PPP contracts is, in the author's experience, often overlooked but cannot be over-emphasised.<sup>197</sup>

Thus, after a brief summary of the reasons why PPP are used, and the roles of the different parties to the PPP, the main focus of this chapter is to address the key issues in planning and managing PPP transactions.

## WHY PPP ARE USED

PPP are used by public authorities for a wide variety of reasons, not all of which are present in every transaction. What is important is that, for each individual case, the public authority understands very clearly its motivation for the use of a PPP i.e. the reason why it is potentially capable of meeting its needs. Often a PPP will emerge as the most appropriate option for service delivery if there is a good *prima facie* reason why it is being considered.

The reasons for using a PPP normally fall into one of the following three categories:

- A PPP is the most appropriate route to meet the need for an improved quality of public services, new services not previously provided by the state or different methods of providing services, which could be driven by public demand, political imperative or the need to comply with EU legislative requirements. It could also happen in circumstances where the delivery of the current service has reached a crisis. or where there is a need for a fresh start in service management<sup>198</sup>
- A PPP is the only way to finance the project, given constraints on the

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<sup>197</sup> The author does not, in this context, consider it necessary to make a detailed case for the importance of proper planning. This is not the function of this book. However, demonstrating evidence of good planning will, *inter alia*, send a signal to the private sector providers and lenders that the public authority has a serious intent to conclude a transaction which will achieve its own objectives, offers a return to service providers commensurate with the risks which it is accepting (subject to the delivery of the contractual objectives) and in these circumstances offers lenders the security that their loan will be repaid. This should be attractive to providers, insofar as they are not following a policy of seeking to deal with Contracting Authorities who are likely to be ineffective bargainers. Put simply, if a Contracting Authority does not plan effectively it is more likely to conclude a contract more oriented to the providers' agenda.

government capital investment budget (especially in a recession or in the context of the need to comply with the fiscal imperatives of current or prospective membership of the euro zone).<sup>199</sup> PPP, representing as they do long term financial commitments to expenditure which, in public expenditure terms, are a mix of capital and current expenditure, can have the effect of contractually enforcing continued investment in the maintenance and refreshment of assets, thus, it is claimed, preventing under-investment. It remains to be seen whether or not any benefits deriving from such contractually enforced investment actually represent value for money

- A PPP is considered to be likely to bring specific financial benefits, such as a reduced cost of service, an improvement in income collection, a more effective use of public assets by utilising spare capacity more proactively and the offloading of residual liabilities from the state to the private sector.<sup>200</sup>

## **KEY ROLES IN PLANNING, PROCURING AND MANAGING A PPP**

### **Role of different parties to a PPP**

The four key parties to a PPP are public authorities, service providers, (often a consortium<sup>201</sup>) lenders (to the extent that the transaction is being privately

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<sup>198</sup> For example, the decision to use PFI in the UK to build and operate new prisons was in part prompted by the desire to redress the balance between the authority of prison governors to manage prisons and the entrenched power of the prison officers trade union.

<sup>199</sup> This often follows a period of under-investment in assets, in which the use of assets has often been prolonged beyond their originally estimated useful life, a process which cannot be prolonged indefinitely.

<sup>200</sup> Under EU law (the Acquired Rights Directive), when the ownership of a business or the delivery of a service transfers from one entity to another, employees transfer with the business to the new employer on the same terms and conditions of employment as with the old employer. This includes their accumulated rights in the event of redundancy, so that, if, as a result of a PPP, employees transfer to the private partner, the state’s liability transfers with them. Although of course this is reflected in the offer by the private partner, there is still likely to be a benefit to the state because the accumulation of its redundancy liabilities stops at the point of transfer. In addition, the new employer may be able to reflect in its offer the expectation of a lower level of redundancies than would have been the case had the service remained with the state, and continued to be financially constrained, because of their potential to use the transferred employees in a wider range of income-generating activity.

<sup>201</sup> The consortium for a typical PPP project will often include a construction firm, a facilities management service provider and a financial institution.

financed) and end users, typically when they are internal customers within a public authority or, in some cases, other public authorities where a public authority is creating a PPP from a service which serves both itself and third party customers.

One example of internal customers within a public authority could be of school head teachers whose schools are the subject of a PPP for the design, construction and maintenance of school premises and their use by users other than the school. This has been a typical arrangement for schools PFI schemes in the UK. Head teachers would not be party to the decision to use a PFI, which would be made by the municipal authority, but would clearly have an important role in the procurement process and the management of the service.

The roles of each party may vary according to the particular form of transaction, bearing in mind the wide diversity of types of forms of transaction which a PPP might take. The overriding principle should be that any role should be allocated to the party best able to undertake it.

In the case of the creation of a PPP to deliver an existing public service paid for by a periodic payment by the public authority with no contribution from end users, the roles of the parties could be summarised as shown below.

### ***Public authorities***

In the case of a service previously delivered by the public sector transferring to a private sector provider through a PPP, the public sector will typically provide the assets to be transferred i.e. the physical, human resources and information assets. Almost invariably the public authority will contribute the land on which the physical assets are to be constructed/refurbished.

The people transferring to the PPP will provide the public service delivery experience, on which the service provider may have placed reliance in its offer.

The public authority is responsible for defining, through the service specification and contract conditions, the scope, performance standards, timing and any requirements re the methods of service delivery.<sup>202</sup> It also often sets the price which it will pay for the service received, either in advance or competitively through the offer process.

The third key role for the public sector is to monitor the outcomes deliv-

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<sup>202</sup> The constraints placed on the methods of service delivery often involve key judgements for the public authority. The way in which they exercise these judgements is often key to the building of public support for the PPP. Many of the most difficult judgements centre around environmental concerns such as the route of a transport corridor and traffic movements.

ered by the service provider and enforce standards. This role exists not just in public service PPP, where it is of paramount importance, but also in free standing PPP. This is because, though the principal determinant of whether or not the service specified is being delivered will be willingness of end users to pay, there will be contractual requirements in respect of the way in which the service is being delivered, such as environmental matters, which the Contracting Authority will need to monitor.

### ***Service providers***

The main role of the service provider is to manage the investment of the PPP, designing, constructing, operating and maintaining the asset. This may include, depending on the terms of the contract, transferring the asset at the end of the contract to the public authority in a condition fit for use or decommissioning it (e.g. site clearance and restoration).

It uses the asset to deliver the service which is the subject of the PPP, often with new management and working practices (with a focus on management to the performance measures in the contract and the targets for those measures). For a PPP to represent value for money for the public sector and be profitable for the private sector, this normally means lower operating costs and/or more effective income collection (and acceptance of risk transfer). In some cases it can also depend on an expectation that the acquisition of the contract will lead to third party sources of income e.g. use of surplus land contributed by the public sector or services to other public authorities or to the private sector. The availability of third party sources of income can sometimes be a driver towards an Institutional PPP.

The private sector partner will clearly also be expected to orientate the style of management used in the delivery of the PPP to ensure that it achieves the particular objectives set by the public authority. These should of course be reflected in the performance measures for the contract, and can include matters such as improved customer service, lower rates of staff absenteeism, more investment in staff training, improved communication with staff and users, improved service marketing and commercial disciplines such as better budgetary control and investment appraisal.

### ***Lenders***

The key role of lenders is to provide the finance for transactions insofar as it is not from public funds and various aspects underlining the importance of lenders to the PPP process have been highlighted above in Chapter 1. Lenders are often particularly active at a late stage of a PPP transaction, when they will want to ensure that the terms of the contract properly reflect their need for security for their loan, bearing in mind that PPP are typically

financed on a non-recourse basis and there is often no other security than the assets in the contract and the cash flows payable for the service delivered. This need for security is true both for private sector lenders and for quasi-public sector lenders such as the European Investment Bank.

It is clear that lenders do not merely lend their money and then passively wait for it to be repaid. They also play a key role in ensuring that the private sector service provider delivers the service agreed in the contract and thus gets paid for it, since without such receipts the service provider will not have the means to repay its borrowings. In that sense, the lenders have a common objective with the public sector in ensuring that terms of the contract are complied with, though the lender will also impose additional disciplines on the service provider, relating to its internal financial management. These relate, for example, to the need for the service provider to have an income margin in excess of the loan repayments to the lender and for the payment of dividends to its shareholders.

Lenders will also have a clear interest in resolving disputes between the public authority and the service provider over whether or not the expected service is being delivered and do sometimes play a role in resolving such disputes in away which is not possible in traditional public sector contracts which are financed by the service provider.

Lenders also reinforce their position through a large number of contractual agreements designed to minimise the risks borne by their borrower, the private sector service provider, and the impact of their borrower's failure to deliver the service to the Contracting Authority.

### ***End users***

Internal customers who are end users of services are the party most immediately affected by the way in which the service is provided, even though they may not have been integral to the decision to initiate the PPP.

There are three roles which they sometimes play in a PPP, and even if they do not play the role formally, the public authority would be well advised, as far as possible and subject to affordability considerations, to ensure that their needs are addressed in the PPP process.

Firstly, internal customers should be asked provide input to the formulation of the contract documentation (service specification and contract conditions), potentially including any of the aspects which the public authority is responsible for defining. This can be done in a variety of ways, though, to ensure that the process is manageable and focused, it is often done by consultation on specific issues.

Secondly, they may be asked to provide input to the partner selection process in different ways such as representation on the evaluation panel,

assisting with checking the track record of potential suppliers or assessing the cultural fit between the potential suppliers and the public authority based on the contacts during the selection process.<sup>203,204</sup>

Thirdly, end users may very well be a source of information which acts as inputs to the monitoring of contract outcomes from user perspective. To continue with the schools example, it makes sense for a public authority to use head teachers, who will be amongst the first to become aware of the need for repairs at a school, to be part of the process of contract management.

### **Managing professional advisers**

Public authorities, service providers and lenders will in practice engage professional advisers to provide legal, financial, operational etc. advice whose competence, commitment and freedom from conflict of interest they will need to be assured of.

In the author’s experience the most difficult and serious judgment is that relating to conflict of interest, particularly in respect of the public sector’s advisers. If these advisers are from a major international multi-service professional services firm, it is in practice rare that this will not arise. The firm may have advised one of the bidders in the past, but, even if they have not, if the bidder is a significant commercial entity, the firm may, unknown to the Contracting Authority, be actively targeting the bidder as a potential future client or currently bidding for advisory work with them in connection with an entirely separate transaction. The network of relationships may be even more complex, and difficult to evaluate, where former senior staff of the professional services firm are now employed by the bidder. All of these issues are of course multiplied where there are bids from consortia.

None of this is to suggest that multi-service professional services firms cannot give impartial advice, and, indeed, the fact that the firm has a track

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<sup>203</sup> The involvement of internal customers in partner selection is, of course, as much subject to personal agendas distinctive from that of the Contracting Authority as that of any other party to the selection process. For a fuller discussion of what may be termed the conflict of interest between the principal (the public authority) and the agent (those responsible for acting on the public authority’s behalf) see Peter Trepte “Regulating Procurement”, Oxford University Press, 2004, p. 70 *et seq.*

<sup>204</sup> The engagement of external customers with the process may also be crucial, especially if they have the short term freedom to terminate their own contract if they are not satisfied with the choice of service provider and where the offer made to the Contracting Authority by the service provider in a PPP is based on the assumption that the core contract (and the people and physical assets transferred) will be used as a vehicle to deliver third party contracts.



record of advising service providers generally means that their advice to the Contracting Authority will be informed by their understanding of the perspective of service providers.

But it does highlight the importance of the process by which professional advisers are selected and the relevance of seeking a full disclosure of their past and current market activity. In doing so Contracting Authorities would, in the author's experience, be well advised to ensure that this disclosure is at an entity-wide level (normally national) rather than at an office, divisional or individual adviser level, bearing in mind the difficulty which the Contracting Authority will have in practice of monitoring "Chinese walls" should these be offered as a means of managing potential conflicts of interest. Put simply, a declaration that an office, divisional or individual adviser has not been or is not currently engaged with a bidder for the current contract is not a sufficient solution to a potential conflict of interest.

## **EFFECTIVE PPP PLANNING**

Effective planning of a PPP can, potentially, include all of the elements which comprise the procurement and management process, since it is clearly preferable if, before the call for expressions of interest is launched, significant issues likely to arise can be anticipated (including those likely to be of particular interest to suppliers). These include key decisions about the selection process, the outcomes, the desired solutions to deliver the outcomes and the conditions on which they will be delivered, resources for the procurement and for contract management and the organisation of the contract management regime.

This may represent an ideal rarely achieved in practice, but it serves to highlight the scope of planning for a PPP and that effective planning is likely to be time consuming. Depending on what preparations are needed, such as for example, the need to obtain planning and other statutory consents, to begin the process of consultation with stakeholders such as the public, employees and customers, to build public support, to research the market, deploy resources, develop a contract strategy and prepare procurement documentation, it may be that the planning stage will need to commence up to twelve months before the launch of the offer process.

The planning process may be conveniently divided into the following elements:

- The need to ensure that procurement objectives are clearly aligned with policy objectives
- The need for high level political commitment

- Undertaking a market assessment, with a view in particular to developing and understanding the possible solutions and their strengths and weaknesses in advance of launching the procurement process
- Determining outcomes sought from the PPP in the light of the market assessment
- Developing a contract strategy, including considering the financing, timing, setting the timetable and other key decisions to be implemented in the procurement process
- Planning for communication with stakeholders
- Assembling the necessary skills for the project
- Planning for continuing public sector client commitment after the selection of the partner.

### **Policy objectives and procurement objectives**

In the detail of managing procurement activity it is possible to lose sight of the fact that public procurement is a means to an end i.e. the policy objective of the delivery of better public services. This is as true of PPP as of other forms of public procurement.

In short, PPP are a means for public entities to achieve their policy objectives, so it is necessary before launching a PPP to ensure that it will achieve an end compatible with policy objectives. Its objectives must also be consistent with other policy objectives and programs of the public authority, and be managed on a coordinated basis (see Chapter 2 above).

It also bears re-emphasis that PPP are not the only means to achieve the objectives of an investment programme and that there are many different forms of PPP, so that in each case it is necessary to confirm that a PPP is appropriate for the particular project and to ensure that the most appropriate form of PPP is selected.

Setting procurement objectives, the decision to use PPP and a particular form of PPP is not, however, a static process. However well planned and prepared a public authority is, it is possible that market conditions can change through events beyond their control and the progress of the procurement process may not be as expected.

There may, for example, be fewer expressions of interest or bids than expected in spite of the public authority’s best intentions to promote competition and offers received may not be of sufficient technical quality or may be unaffordable. There may be an unexpected event which renders a particular risk unacceptable to the private sector. There may be a policy change by another entity which impacts on the viability of a PPP. There may be a legal

challenge to the procurement process.

Because of the possibility of these circumstances arising it is important that a public authority incorporates into its planning process points at which the appropriateness of the use of PPP, its ability to achieve its original objectives, its particular form and the extent to which it continues to represent value for money.<sup>205</sup>

### **Political commitment**

A successful partnership is much more likely to result if there is commitment at a high level. This follows from the fact that a PPP involves significant bidding costs for interested parties, long term commitments are needed from both the public and private partners and lenders and the fact that there may be political opposition to a project.

Thus senior public officials must be willing to be actively involved in supporting the concept of PPP and taking a leadership role in the development of each given partnership. A well-informed political leader can play a critical role in minimising misperceptions about the value to the public of an effectively developed partnership.<sup>206</sup>

### **Market assessment**

A detailed assessment of the market is crucial to the development of an effective contract strategy for a PPP and will normally involve four elements.

Firstly, an assessment of any previous similar contracts let by the Contracting Authority or any other Contracting Authorities which form part of its network. It is worth considering the strategy adopted for those contracts, identifying the outcome of decisions taken, accessing its post implementa-

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<sup>205</sup> See above, note 63 for a summary of the UK OGC's Gateway™ procedure, which is widely regarded as meeting this need for review. There can, of course, be circumstances where the public authority changes its policy objectives and/or procurement objectives during the course of a procurement. This may or may not be justified, but, even when it is in a particular case, it can have an impact on the market's perception of the credibility and reliability of a public authority, with a potential impact on interest in the current or any future PPP.

<sup>206</sup> Though they were not PPP, gas and electricity privatisation in the UK are example of how an effective public communication campaign can manage potential opposition to a novel project.

tion review and discussing them with those responsible for implementation, reviewing any available audit reports, and, if possible to checking the current performance of the provider.

Secondly, an assessment of the current state of the supply market, including other known opportunities which are available.<sup>207</sup> This could be done through desk research and use of public sector networks.

Thirdly, market consultation with potential suppliers before the start of the formal offer process. This can help a public authority avoid including deal breakers in its requirements i.e. matters which would lead bidders not to bid or high risk requirements for a private partner to accept, thus needing a high risk premium which may jeopardise the value for money of the PPP and identify what market regards as important to the viability of a transaction. The scope of the consultation may embrace the service specification (including processes, inputs, and service outcomes), the contract conditions and structure of the PPP, including the proposed allocation of risks. This can have the benefit later in the process of reducing the scope of the dialogue or negotiation needed, by addressing issues up-front.

It is also an opportunity for a public authority to informally signal its requirements to the market and to gauge level of interest in an opportunity and to show its competence to market (i.e. that it has clear objectives and an intention to conduct a transparent and competitive process in a defined way to a known timetable).

It follows that the way a market assessment itself is conducted can be a major factor in encouraging or discouraging interest – if a Contracting Authority conducts it in a way which suggests that it is inflexible or would be difficult to work for, it may have a negative impact on the level of interest.

Generally, and particularly for PPP likely to attract international interest, major suppliers will have a choice of opportunities e.g. municipalities all over the transition economies are trying to engage with private sector partners for service provision in the field of waste management, so a Contracting Authority needs to be aware that it may be competing for supplier interest.

The use of market consultation (in addition to desk research and user networks), which does not represent any commitment on behalf of either the public authority or the private partner, does not breach *per se* the principles of equal treatment and non-discrimination,<sup>208</sup> though it needs to be conducted with care, particularly if done face to face. Consultation on specific issues rather than open ended discussion and avoidance of negotiation can help to uphold these principles and in some cases it may be possible to have

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<sup>207</sup> See above, p. 41 for a more detailed description of the scope of market assessment.

the consultation conducted anonymously i.e. conducted by third parties on the public authority's behalf. It can sometimes be useful to engage consultants to undertake this task.

Some public bodies use a bidders' conference as part of their market consultation i.e. open discussion with anyone who chooses to attend. They can be used to explain the objectives, timetable, key deliverables, key economic, technological, political etc. issues for the Contracting Authority. They have the merit of being transparent and reduces the risk of unintentional unequal treatment/discrimination, though non-national companies may be less likely to attend. But they can be time consuming to organise – it is particularly important to determine how to respond to questions raised both at the conference and subsequently, because otherwise there is a risk that they may actually deter rather than attract it. There is also the limitation that in open discussion in the presence of their potential competitors, the participants may be less willing to give the frank feedback on which the value of market consultation depends.

Fourthly, market consultation with lenders before the start of the formal offer process.<sup>209</sup> This will be similar to that with service providers, focusing on issue of particular relevance to lenders.

The objectives of market assessment may be summarised as seeking to help the public authority answer the following questions i.e.

- Which providers are likely to be interested in this contract? (considering its value, subject matter, timing, novelty, technical complexity etc.)
- Is this enough to provide sufficient competition? (considering the minimum number required by law and need for value for money, possible withdrawals during process, the contract size and likelihood that there will be, or need to be, consortium bids)
- What do potential suppliers and lenders think of the possible opportunity? (considering the affordability of the opportunity given the budget and its technical feasibility)
- What is the reputation of the Contracting Authority with suppliers? (given the outcome of past procedures completed and considering impact of cancelled and failed procedures)

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<sup>208</sup> Recital 8 of Directive 2004/18 says that “Before launching a procedure for the award of a contract, Contracting Authorities may, using a technical dialogue, seek or accept advice which may be used in the preparation of the specifications provided, however, that such advice does not have the effect of precluding competition”. Market consultation is one form of such a technical dialogue.

<sup>209</sup> It is a given that, where market consultation is used, a Contracting Authority should formally determine, or at least let all consultees know, that the consultation phase has been completed.

- What will encourage and/or discourage interest in the contract? (considering the contract terms, timing of the offer, procurement timescale, contract execution time scale, the award procedure chosen, performance standards expected, the planned conduct of procurement procedure, particular contract conditions such as guarantees and warranties required, termination liabilities and allocation of risk)
- What aspects of the contract or the award procedure etc. will act as barriers to bidding or lead bidders to incorporate high risk premiums in bid prices?

At the conclusion of the market assessment phase, a public authority should, in summary, be in a position to determine:

- If the market can offer what it wants in the form that it provisionally identified in its assessment of business need in a way which is likely to be technically feasible, financially sustainable and politically acceptable
- The likely level of interest in the contract and the issues which will affect the level of interest
- The willingness of lenders to finance the PPP
- How much it knows about the business and technical issues in the market – and thus the gaps it needs to fill before launching the procurement process
- How it will respond to the view of the market on the attractiveness of the opportunity.<sup>210</sup>

### **Determining outcomes sought<sup>211</sup>**

The conduct of the market assessment should place a public authority to refine its assessment of the outcomes achievable from the PPP. This will include detailed draft contract terms, the responsibilities of public/private partners, the allocation of risks between the parties and an understanding of

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<sup>210</sup> Responding to the needs of the private sector on the attractiveness of the opportunity does not mean automatically to accommodate all of the market’s wish list in such a way as to put at risk value for money. Similar issues can arise in the contract award stage where the author has experienced pressure from service providers to move very quickly to the selection of a preferred bidder with many of the significant contractual issues not finalised. Often this has been called for by the private partner on the grounds that it ends the uncertainty for staff about the future delivery of the service. But the advice that this pressure should be resisted to ensure that key contractual conditions were resolved while there is still competition, never, in his experience, led to the withdrawal of service providers from an award process.

the solutions likely to be proposed, including the investment needed, the service specifications, performance standards, key contract conditions, and any asset transfers and staff transfers from the public sector.

### **Developing a contract strategy**

The contract strategy is the means by which the Contracting Authority seeks to achieve its objectives and follows from the previous steps in planning the PPP award.

The scope of the contract strategy for a PPP is potentially very wide but can include such matters as:<sup>212</sup>

- How the contract will be financed i.e. with a mix of public and private finance<sup>213</sup>
- Whether or not the contract could be combined with a contract for similar services with another government department, sector within the department or another sub-national administration (bearing in mind the impact this might have on the number and type of suppliers who will be interested, and possible compromises which might need to be made about the service specification etc.)
- Dealing with potential conflicts of interest e.g. ruling out categories of supplier and/or determining what are acceptable ways in which suppliers can deal with such conflicts? (considering, for example, other work being done for the Contracting Authority, other activities of the supplier in the sector relevant to the PPP or other sectors etc.)
- The award procedure to be used (e.g. the restricted, competitive dialogue or negotiated procedure, in the light of the need for promotion of competition, manageability and need to justify the competitive dialogue

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<sup>211</sup> It bears repeating that there will be no partnership unless the private partner can make a profit commensurate with the risks it is taking. The judgement about what is reasonable but not excessive profit for the private partner is often difficult, not least because it may be undermined by other public authorities which are less diligent, more willing to allow the private sector a higher level of profit or who have prioritised a project so highly – or made public political commitments – so as to have little bargaining power. These may give private sector providers the chance to cherry pick opportunities. The level of reasonable profit may change over time, as a particular type of project becomes less novel. All of this reinforces the case for effective management of a national PPP programme as described above in Chapter 2.

<sup>212</sup> This is not meant to be an exhaustive list but all of these considerations are relevant to the planning of a procurement.

<sup>213</sup> This will also include consideration of the extent to which the end user would be prepared to pay for such a service.

- or the negotiated procedure)
- The contract length i.e. considering matters such the nature and size of the investment to be made by the private partner, the period over which lenders will lend, the balance between the competitive value of a shorter term contracts and the stability, continuity and potentially lower yearly costs of a longer term contract and the flexibility needed by the Contracting Authority given the likelihood and scope of possible of future change in the pattern of demand for the service and methods of service delivery
- Determining the appropriate allocation of risk between the public and private parties
- The need for interim review periods and break point dates in the contract and how these will be dealt with
- Whether or not the entire contract will be awarded to a single supplier or whether the total requirements will be divided in some way, considering matters such as the need to avoid the delivery of the service being excessively dependent on interface between suppliers and the consequent difficulty of setting performance targets for which the private partner can be held accountable<sup>214</sup> and the value of maintaining alternative sources of supply and/or “corporate memory” to deliver the service directly
- When the opportunity will be launched
- Where the Contracting Authority will advertise the opportunity i.e. beyond the OJEU and other official national sources, which will in part depend on what kind of partners the public authority is expecting to attract
- The timetable for the procurement which, in addition to complying with public procurement law, should be:
  - Launched at a time which will optimise competition
  - Realistic for the Contracting Authority (i.e. allowing sufficient but not excessive time to prepare documents and information, assess expressions of interest, to develop its thinking of the preferred outcome after initial supplier proposals, conduct the dialogue in the case of a Competitive Dialogue procedure, assess tenders, and review progress).

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<sup>214</sup> In an accommodation type contract (such as a school, hospital or office accommodation) one of the key decisions is whether or not the same provider should be awarded the “hard” facilities management services (e.g. the building maintenance) and the “soft” facilities management services such as cleaning, catering, security and laundry) or whether the “soft” facilities management services should not form part of the contract at all. This is in addition to the decision about whether or not clinical/educational/custodial services should also form part of the PPP contract. The logic of PPP is that design, construction and the provision of some services are embodied in the same contract.



A realistic timetable for partner selection is very important and ideally should not be compromised by an unduly inflexible pre-announced deadline for the realisation of the project<sup>215</sup>

- Appropriate for suppliers in the light of the value, complexity and sometimes location of the contract i.e. allowing bidders sufficient time to express interest, participate in dialogue and submit detailed and as far as possible unconditional offers, but not be too long, thus not unnecessarily adding to bidder costs (and the costs of the Contracting Authority). More than the minimum time may be needed to maximise competition especially for tenders where international interest is expected
- Minimise period of negotiations with the preferred bidder having single tender status, if the negotiated procedure is being used
- The information to be included in the contract notice and the call for expressions of interest, bearing in mind the overriding principle that calls for expressions of interest should act to encourage capable suppliers and discourage those not capable of satisfactorily fulfilling the Contracting Authority's needs
- The short listing criteria (including the minimum financial, economic and technical capability required of a supplier and the means of reducing capable suppliers to desired short list number), bearing in mind the principle of proportionality i.e. not calling for levels of turnover, assets, experience or number of employees which exceed the capability needed for the contract<sup>216,217</sup>
- The information to be requested from interested parties and the form of that information. In doing so a public authority should take into account considerations such as setting the minimum financial, economic and technical capability required to ensure that only capable suppliers can

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<sup>215</sup> Pre-announced deadlines – often driven by publicly made political promises– can compromise the negotiating position of a public authority but are often the corollary of the need for political commitment for a PPP project. One example was the UK government's benefits payment card scheme launched in 1996 for the electronic payment of social security benefits and abandoned three years later. One year into the project, the supplier said that meeting the deadline would cost 30% more than originally expected (see Michael Cross, "Public sector IT failures", *Prospect*, October 2005).

<sup>216</sup> There can be an element of self interest in proportionality for the Contracting Authority because it is not in its interest to have as private partner an entity to whom it is not an important customer, which might occur if the service provider is too large relative to the contract.

<sup>217</sup> The absorption capacity of the potential partner is a relevant factor i.e. the extent to which an entity can increase its turnover by a significant amount and/or absorb several contracts simultaneously.

reach the short list, encouraging those who express interest to share ideas (and thus show good faith and serious interest) at short listing stage, using the short listing process to give opportunities for interested parties to show cultural fit with the Contracting Authority (e.g. attitude to and track record in partnering) and assessing how important the Contracting Authority will be as a customer to the supplier<sup>218</sup>

- The target number to short list, bearing in mind the legal requirements for the short list
- The decisions necessary re the launch, conduct and conclusion of the dialogue phase of the Competitive Dialogue (see above, p. 90 *et seq*). Many of these decisions will be common to other award procedures
- The information to be requested from the short list/dialogue participants and the form of the solutions/offers, taking into account factors such as the manageability of the process, the relevance of the information requested to the award criteria and the need, as far as possible, to minimise the bidding costs of the participants in the process
- The offer evaluation criteria (including the weighting of the criteria<sup>219</sup> and the price/quality balance)
- The performance standards needed (taking into account the need to balance price and performance and the extent to which the need for improved performance is a key reason for undertaking the PPP and the results of any service review undertaken before the award process is commenced)
- The key elements of the service specification, considering the balance between specifying outcomes needed rather than methods to be used in achieving outcomes and the need to prescribe any specific level of inputs
- Key contract conditions, such as those relating to ownership of assets, termination liabilities, gain sharing on refinancing, other windfall gains, change of ownership of provider, service commencement date, definition of availability of service, price indexation, compensation on com-

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<sup>218</sup> There is some debate amongst legal practitioners about how exhaustive the selection criteria listed in Art 47-50 of Directive 2004/18 actually are and thus how best to incorporate considerations of suitability for partnership into the short listing stage. The debate centres on the interpretation of Art 51 which allows Contracting Authorities to “invite economic operators to supplement or clarify the certificates and documents submitted pursuant to Articles 45 to 50” and in particular what supplementary information can be requested in respect of the “ability of economic operators to provide the service or to execute the installation or the work” which “may be evaluated in particular with regard to their skills, efficiency, experience and reliability” (Art 48(5), Directive 2004/18).

<sup>219</sup> Now normally required by the Public Procurement Directives. See Art 53, Directive 2004/18.

plete or partial termination of the service, performance guarantees, insurance, warranties, indemnities, amount and scope of the supplier's liability for direct and indirect losses, definition of *force majeure*, the performance management regime, step in rights for lenders, step in rights for the Contracting Authority, dispute resolution etc.

- Payment mechanisms (considering the options of fixed sum or volume related unit payment, rewards for early completion, penalties for non-performance, guaranteed minimum volumes/price variation if there is volume variation etc.). The payment mechanism should encourage good supplier performance and discourage sub-optimal behaviour such as its being more profitable for a supplier to incur penalties rather than make good service failures<sup>220</sup>
- The Contracting Authority's approach to bids by groups of bidders (considering establishing contractor responsibility, manageability for the Contracting Authority of the procurement and contract management procedures and the wider issue of consortium bids on competition)
- How contract variations will be managed to ensure continuing value for money while maintaining flexibility to change requirements if service needs change
- Whether or not variant bids (or, in the case of Competitive Dialogue, more than one solution) will be allowed either as alternatives or as additional offers (considering the need to encourage innovation, the need to facilitate the comparability of offers and assessing value for money, the impact on the Contracting Authority's control of procedure and the impact of allowing variant bids on bid costs of participants)
- The desirability of requesting or requiring sub-contracting or not and what control if any the Contracting Authority would wish to exercise over the supplier's second tier supply, such as the requirement for them to meet minimum capability requirements, be selected competitively and for their value for money to be benchmarked
- Considering how any staff transfers, physical asset transfers and intellectual property asset transfers will be dealt with, both at the beginning of the contract and the end, where the Contracting Authority will normally want to be able to recover such assets if they need to
- How to ensure that the bidders obtain finance for the project by a competitive process insofar as private finance is required

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<sup>220</sup> It is not unknown for this to occur – some commentators have, for example, attributed the continuing high level of water leakage in the UK water network post-privatisation in 1990, in spite of significant – and long overdue – investment to the fact that the regulatory regime does not sufficiently penalise this type of failure.

- Arrangements for verifying the robustness of the financing arrangements proposed by bidders
- The reasonable profit margin for the supplier in the contract and any provisions for profit sharing, disclosing, adjusting or controlling profit margins, which could include a requirement for open book accounting, giving public sector auditors the right to audit the records of private partners, the use of a probity auditor and/or the creation of a surplus profits pool for allocation at agreed points during the contract
- Arrangements for checking that the value for money decision to use PPP is updated during the procurement process, and especially before award
- Whether or not exclusivity to the private partner applies to additional works under the contract
- How to value assets contributed by the public sector to the PPP
- How to ensure that assets to be transferred back to the public sector at the end of the contract are in fit condition or for valuation of assets if they are to be transferred back at a value representing their age and condition.

The conclusion of the contract strategy phase is to determine the preferred approach to the PPP. But it must be emphasised that in some cases the preferred approach may need to be modified in the light of the conduct of the procurement e.g. the Contracting Authority may initially plan to short list four candidates but if there is an unexpectedly high demand may wish to short list, say, six candidates. The Contracting Authority should always bear in mind the need to provide itself with some flexibility, though this should not be used as an excuse for lack of clear advance thinking.

It should also bear in mind that, though the contract strategy will not be a public document in itself, much of its content will be placed in the public domain as part of the information available to suppliers and will thus reflect on the realism, competence and clarity of thought of the Contracting Authority.

### **Planning for communication with stakeholders**

The scope of those affected by a partnership will be, and should be seen as, wider than just the public officials directly responsible for making and executing the procurement decisions and the private sector partner.

Employees, public end users, internal customers/end users, the press, trade unions and other third party interest groups will all have opinions, frequently have significant misconceptions about a partnership and its value to

all the public, and will have their own agendas about the outcome of a PPP. As far as possible, their needs should be accommodated. This may be difficult in some cases because PPP as a concept sometimes generates opposition which may or may not be justified by subsequent delivery of the service and is sometimes ideologically motivated or by self interest. For example, some residents of a locality in which an airport or a waste treatment centre is to be built will never be persuaded of the case for the project. In that sense it may be impossible for a public authority to win *ex ante* public approval for a PPP. But in those circumstances it is even more important for it to ensure that it accommodates as many of the valid issues raised by objectors so as to manage the process effectively.

So part of the planning for a PPP will be a communication strategy. It is important to communicate openly and candidly with stakeholders to minimise potential resistance to establishing a partnership. It is possible to be open in many of the matters in the contract strategy and to consult upon them, such as the formulation of the short listing and award criteria, the design of the service specification and setting performance standards.

But it is usually desirable from the point of view of the Contracting Authority, and in any case now protected in principle in the Public Procurement Directives, that information supplied by the participants in the process – e.g. expressions of interest, submissions during the dialogue phase of a Competitive Dialogue and offers should be kept confidential to those directly involved in making decisions about the award process. The ability to do this effectively also builds confidence of participants in the competence of the management of the process by the Contracting Authority.

This may mean different levels of communication at different stages of the procurement process, but clearly, by opting to communicate transparently at as many stages of the process as possible, the Contracting Authority can maximise the trust that it builds in the fairness of its approach which it can rely on at the times when it is unable to be open, such as the assessment of expressions of interest, during the conduct of the dialogue phase in a Competitive Dialogue and the assessment of offers.

### **Assembling the necessary skills for the project**

At a practical level, the Contracting Authority will at the planning stage also have to determine the resources needed for running the award process and who will be responsible for the tasks to be performed by the Contracting Authority taking into account the skills needed, the experience of procurement team members in the type of procurement proposed, the time available

and the need for outside experts etc. Major procurements which are well conducted can be very demanding on the time of those involved.

The project team will need to reflect different stakeholders and skills such as finance, legal, operational/technical, human resources (especially if there are staff transfers) and procurement will need to be represented as well as end users and external customers if appropriate.

### **Planning for continuing public sector client commitment**

Once a partnership has been established, the public sector must remain actively involved in the project or programme. On-going monitoring of the performance of the partnership is important in assuring its success.

A fuller description of the approach to contract management is set out below – but it is at the planning stage that the organisation structure, frequency and methods of contract management – as well as the performance measures – need to be first addressed and set out in the information provided to interested parties and, in more detail through the contract documentation, to the short list. The structure and *modus operandi* of the contract management regime may be a factor in determining whether or not bidders actually submit offers i.e. it is part of the risk assessment for service providers and potential lenders. Development of the contract management regime during the award process also helps to ensure that the arrangements are actually in place from the inception of the contract and able to deal with what can often be difficult early issues.

## **EFFECTIVE PPP CONTRACT MANAGEMENT**

### **Importance of contract management**

The achievement of value for money in PPP contracts comprises two stages i.e. effectively applying a transparent and competitive procurement process to achieve value for money in the procurement phase and effective contract management to ensure that procured value for money becomes realised value for money.

Because PPP procurement processes are often lengthy and resource intensive for a public authority and conducted to deadlines, it is very easy for the pressures of the procurement process and sense of achievement at selecting a partner to lead to neglect of the contract management process. Good planning and selection can thus be undermined by lack of attention to con-

tract management.

This is not merely a question of creating the right structures, processes and monitoring regime – it is also a human resource management issue. Put simply, the contract management team matter – if they do not care about the delivery of the contract, the public authority will not achieve its contract objectives. So it is important that a public authority send the right message to its contract management team by ensuring that they have appropriate resources, skills, information and authority and can exercise it in the context of a well structured performance management regime.

This section focuses on the management of contracts which are in essence public service PPP but many of the issues arising are relevant to concessions, including the definition of the means by which the service is delivered.

## **Measuring performance**

The cornerstone of an effective contract management regime is the obligations of the private partner in the contract. These should be recorded in a contract management guide which includes the key elements of the contract.<sup>221</sup> These are important in any case in the interests of clarity between the partners but are particularly important as the contracts evolve and new personnel become engaged on both sides.

These will comprise a combination of:

- Performance measures associated with service delivery
- Other, often longer term, commitments made by the partner associated with, for example, investment and maintenance and/or creation of employment.

The selection of the appropriate performance measures, and the targets for them, is a skilled activity which needs to be undertaken at the planning phase of the PPP. They will define the objectives of the public authority, will act as a signal to potential bidders about what is expected and will form part of the assessment of the lenders about the risk associated with the transaction i.e. the likelihood that the service provider will fail to deliver its obligations, be subject to financial penalties and thus, possibly, be at risk of being unable to meet its loan obligations.<sup>222</sup>

Everything which is important to the contract should be measured so the

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<sup>221</sup> And should also include the contract management procedures described later in this section.

performance measures indicate the level of achievement of the desired outcomes of the contract overall. These measures and the targets for them must reflect the Contracting Authority’s objectives, including political priorities.

Other key factors influencing the choice of performance measures and targets are that:

- ***The measures must be manageable.*** There must be a realistic (i.e. not excessive) number of measures to focus on real priorities and to make the monitoring of supplier performance manageable from the point of view of the Contracting Authority
- ***The measures should be output and outcome based, with minimum necessary specification of inputs and processes.*** While public authorities will have process requirements, which should generally be addressed through the service specification and contract conditions, these – and any input requirements – should be minimised in the performance management regime, so as to allow the public sector to benefit from the innovation which the private partner is capable of bringing to the partnership
- ***Suppliers will tend to do what is measured.*** Suppliers will wish to avoid financial and other penalties which might be incurred in areas where they fail to perform. They will therefore aim to achieve at least the minimum required level in areas that are being measured (and for which specific performance targets will have been set)<sup>223</sup>
- ***Suppliers cannot be criticised for failure to do what has not been deemed “important” by the measures.*** If, by definition, the agreed performance measures represent what is important to service delivery, then the suppliers can be expected to focus their attention on these matters. Therefore it is not appropriate to give signals that matters excluded from the measures are regarded as part of an assessment of contract performance. Organisations managing contracts find it very difficult to avoid establishing implicit performance measures which were not clearly defined at the time the contract documentation was prepared. Nevertheless, it is important to make every effort to do so in order to develop

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<sup>222</sup> Perhaps the best example of the contract structure determining the performance measures is the London Underground PPP. Here it was decided that the operation of the service should remain with the public sector but that three different private partners (with geographical responsibilities) would maintain the infrastructure. The separation of functions between operations and infrastructure deprived the public sector of using the obvious performance measures for the private partners i.e. the punctuality and reliability of train services. This required them to create performance measures for the impact of maintenance on services which were difficult to understand conceptually and complex to calculate. See Wolmar, *op cit*, pp. 121 *et seq.*



- trust in the relationship with suppliers
- ***The measures should be expressed as performance during a period of time.*** It is important that the focus of performance management should not be on individual incidents or days but on a sustained level of performance over a period of time. The measures need to be defined to ensure that this is the case. This principle does not prevent a public authority from undertaking urgent and specific investigation of what it defines as serious service failures or imposing deductions from the periodic payment for them. Nor does this approach to performance monitoring excuse the supplier from taking action to rectify non-serious service failures even if the overall level of performance on a measure exceeds the target
  - ***The targets for the performance measures should be appropriate*** i.e. encourage improved performance, both in the short term and over time. It is generally considered desirable to:
    - Aim for a noticeable but not dramatic immediate improvement in performance. The aim of a performance management system is to improve performance over time or at least sustain an acceptable level of performance. The targets, and the fact that they represent an improvement, will be clearly stated in the contract documentation
    - As far as possible be evidence based i.e. derived from performance levels on other comparable contracts
    - Have an agreed future target date for achieving and sustaining any significant improvement on existing performance
  - ***The targets for the performance measures must be clear*** i.e. it must be clear what is and is not acceptable performance
  - ***The measures should include both measures of immediate perform-***

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<sup>223</sup> Contracting Authorities sometimes complain that suppliers only achieve the minimum standards required by the contract. Given that the Contracting Authority has normally set the standards originally, this is a misplaced complaint and ignores the fact that often these minimum standards are higher than what was being achieved before the PPP. It sometimes reflects the fact that Contracting Authority wants to receive a higher standard of service than it can afford to pay for, which illustrates the fact that the linkage between service provided and cost of service is not avoided by a PPP. Setting targets for performance measures is far from easy, balancing the need for improvement, the long term lock-in to the standards and the desire for targets to be achievable by the private partners so that the PPP looks to be successful. It is often useful to conduct a service efficiency review before setting targets for a new contract. to avoid handing the private partner easy efficiency gains. Setting targets for performance measures also highlights the linkage between clinical and facilities management services in a hospital PPP, where, for example, a change in clinical standards, such as a desire to combat hospital-based infection, may lead to a need for higher standards being expected in a cleaning contract than had been initially agreed.

**ance and measures relevant to performance sustainability and which may provide early warning of future failure.** These longer term corporate health indicators may include, for example:

- **Operational health monitoring targets**, where appropriate measures might be sickness absence levels, staff turnover levels, average hours worked by the supplier’s staff working on the contract, number of days training for their staff. These measures are based on the premise that the supplier can work assets harder and draw down on the existing skill base in the short-term to maintain service delivery standards. Over time, however, there may be limits to the extent to which the key assets of the business can be worked harder if not enough of them are being deployed. These indicators are likely to reveal evidence of stress in the use of key assets
- **Financial health monitoring targets.** Security of supply is likely to be one of the criteria which an authority will use to select a suitable supplier, based on an assessment of the financial stability of the short listed bidders. This is because one cause of contract failure could be a lack of financial stability of the supplier. Significant deterioration in operational performance could derive from deteriorating financial stability. To guard against this, the following checks should be undertaken as part of the monitoring procedure i.e. a check of the credit rating of suppliers with established credit rating agencies, liquidity and profitability checks on the annual financial statements of suppliers, review for the presence of any significant contingent liabilities and a review of the credit rating, liquidity and profitability of the group of companies to which the suppliers belong by applying similar tests to the consolidated accounts of the group. In each case, these could be done against minimum targets for acceptable outcomes.  
Many authorities regard this process as being relevant only as part of the award process but they continue to be relevant throughout the life of the contract so all of these checks be repeated at annual intervals, to be carried out one month after the last date by which the supplier should by law have filed its annual financial statements with the appropriate authorities (such as, in the UK, the Registrar of Companies). If, between these annual checks, there is sustained unfavourable evidence from the early warning indicators of operational performance (see below), there should also be a check of the credit rating with established credit rating agencies
- **The measures should include an indicator of end user satisfaction and measures of the supplier’s partnering behaviour.** These could include matters such as frequency of requesting contract variations, attempting to

pass risks back to the Contracting Authority, timeliness of providing performance information, provision of the partner's forward plans, information about the way in which conflicts are resolved and skills transfer to the public sector.

The objectives of contracts can change over time – this is quite likely in very long term contracts such as PPP – and thus the performance measures and targets may change in line with them. There may be a need to delete some measures and add new ones. This could for example happen if:

- External circumstances change, and the importance to the public authority of certain aspects of contract performance may change, and it may become necessary to place greater (or lesser) importance on a specific area. If this is done, however, it should be done transparently – i.e., by explicitly changing the measures rather than, as referred to above, seeking to introduce different priorities implicitly
- Individual service enhancements are implemented or new services added to the contract. Overall, however, if the relative balance of difficulty in achieving the targets changes materially from that set out at the time the contract is let, the supplier may seek to treat it as a contract variation.

As noted above, any such change should be made explicitly and not by accidental evolution i.e. not by allowing “informal measures” to creep in to the evaluation process.

It is self evident that one of the outcomes of a performance management regime could be the imposition of deductions from the periodic payments to the service provider. Failure to make such deductions when justified undermines the ability of the Contracting Authority to ensure that procured value for money is converted into delivered value for money.

Such deductions in general should:

- Be made in circumstances set out very clearly in the contract documentation
- Be progressive, in the sense that the penalties for repeated failures should become more severe
- Be related to the costs incurred by the Contracting Authority as a result of the failure, which may or may not include some element of indirect or consequential losses.

As noted above, lenders will often seek to cap the level of deductions from the periodic payments (typically at 10%) of to protect their income stream. Contracting Authorities will need to make a judgment about how far

to concede this requirement, given that, if set too low, it could undermine the incentive both of SPVs to deliver the service and lenders to ensure that they do so.

## **Contract management**

This section is focused on the public sector’s perspective and is written from a contract management model and it is important that the right structures, procedures and resources are in place to ensure that the outputs are achieved. But this does not necessarily mean that the relationship between the parties need be driven proactively only by the public sector. The structures created should allow, for example, for the private partner to place issues on meeting agendas and to be proactive in proposing service changes and improvements as well as drawing up initial versions of the annual service plan and the annual investment plan. It is, however, crucial that the public sector has the resources, time, skills and responsibility to make the ultimate decisions on these matters, thus retaining effective control of the contract.

The argument is sometimes advanced that PPP, as a form of partnership, is an inherently different kind of transaction from a contractual arrangement. This is often taken to imply a greater degree of negotiability about the public sector’s objectives. But to accept this view of PPP would potentially undermine the key idea that, in the end, a PPP is a contract to deliver services to the public. In that sense while contract management arrangements need not, and should not, be based on continuing conflict between the partners, they are of their very nature to some extent inherently adversarial.

The key decisions which a Contracting Authority will have to make in respect of the structure of its approach to contract management relate to:

- Resourcing of the contract management function
- The monitoring and investigation structures and the procedures to be used
- Its approach to key contract monitoring issues
- The creation of an effective service planning regime.

## ***Resources***

An early decision is called for in respect of the volume and nature of the resources to be devoted to contract management. Often, an initial assessment will be made during the procurement planning phase, which will need to be updated and re-validated during the procurement phase. In this way, the Contracting Authority is obliged to think about management – its practicability, the approach and its cost – as factors when planning the outcomes it is

seeking to achieve and assessing the most appropriate means of achieving them. It reduces the risks that contract management will be treated as an afterthought and that the mechanisms will not be in place (people, training, procedures) before the start of contract delivery.

It is very important to avoid under-resourcing the contract management function – though it is a mistake often made. This is particularly true as, at least initially, the public authority will be at a disadvantage to the supplier because it will have much less experience of contracting. Under-resourcing the contract management function sends the wrong signals both to the private sector partner and to the staff deployed in the function i.e. that the public authority does not regard contract management as being of high importance.

It is difficult to be definitive about the resources to be deployed for contract management in terms of a number of people. Some authorities define the resources in terms of a percentage of the contract value. Concrete evidence is hard to find, though in discussion with practitioners the range typically cited is 2.5% to 3% of contract value.

The appropriate resources will, however, depend on the skills, experience and seniority of those assigned to the task, the monitoring methods used and the extent to which reliance can be placed on contract performance information generated by the supplier. The role of the end users in managing and monitoring the contract will also be a factor, as described above.<sup>224</sup>

It will also be related to the contract lifecycle (see below) where in general greater resources will be needed in the transition phase (the period between the signature of the contract and the start date), early implementation (which in a PPP will have two elements i.e. the early construction phase and the early service delivery phase) and the end of contract phase, especially if it is a premature termination or there is a change of supplier. In these phases, the public authority may very well be advised to deploy temporary resources in addition to the core monitoring team, in some cases using expert outside consultancy assistance.

As regards the skills needed to undertake contract management, these will generally include a mix of finance and operational/technical skills with the scope to draw on legal human resources and procurement skills as well as end users and external customers if appropriate. This is a mirror of the skill set needed (see above) for the procurement team. Indeed, some initial continuity of personnel from the procurement team is generally regarded as a significant factor in ensuring that procured value for money is realised in

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<sup>224</sup> It is also self evident that the greater complexity of the performance measures, the greater the resource needed to monitor their implementation.

the delivery of the contract.

In terms of the profile of the contract management staff, they will generally need, in addition to their functional skills, to display:

- Knowledge of the subject matter of the contract. This is crucial, particularly in technically complex PPP where the service quality-reducing effects of any cost savings by the service provider (either in the design and construction phase or the operation of the service/maintenance of the asset) is not immediately apparent and/or is not apparent without technical knowledge of the subject matter of the contract. A technically skilled contract management function can thus widen the scope of projects potentially suitable for PPP, because they are well placed to assess the appropriateness of design proposals, performance against targets, service delivery and maintenance activity and the design and implementation of new investment etc. and thus to allow for a greater incompleteness of the contract than would be possible without such expertise
- Ability to take a balanced approach about supplier needs i.e. understanding what the supplier needs to do to make a profit, explaining this sometimes internally within the public authority and in some cases resisting the supplier’s arguments
- Ability to share experience and expertise both within the team and in developing a corporate knowledge base.

This is thus not a part time role, nor to be allocated to staff who are too junior to exercise authority and judgment, or for those who are reluctant to undertake it.

A public authority also has to address the issue of the continuing motivation of contract management staff. Because it forms a crucial component of the effectiveness of the function, a public authority needs to consider how it will meet the continuing training needs of these staff. Many will be coming into a new function, and one which will evolve over the life of the contract.

Secondly, while some will be time limited secondees from other functions, including from the procurement team, others will be seeking to make contract management a career strand. But there is as yet little evidence that contract management is becoming a career in itself, and, in the interests of maintaining continuity in the contract management function, it is relevant to consider how far it should become so, given the need to balance the function between longer term and shorter term personnel.

The need for appropriate resourcing is particularly though not exclusively true where PPP is being used even though some of the common indicators of when it is likely to be optimal – e.g. likelihood of limited change,

known and well understood technology, balancing cost savings and quality reductions etc. – are absent or where the intervention of the Contracting Authority is needed to maintain equity between service users. Contract management costs are a factor to be taken into account in determining the most appropriate implementation route for a project (i.e. they should be factored into the PSC because they may vary between the different options) the relative difficulty of contract management should not *per se* be a sufficient reason in itself *not* to use PPP.

Put simply, it is hard to argue that a well resourced, appropriately skilled contract management function cannot effectively manage a PPP contract if, based on the prior assessment in the investment programme or the PSC, this is indicated as the route giving value for money.

### ***Structures and procedures***

There is no one ideal structure for contract management but it is generally considered to be good practice that there should be a structured approach, matching appropriate personnel from the public authority and the supplier. This allows for a balanced process of delivery, operational and strategic review, and, if necessary, well-defined escalation in dispute resolution and can be as rigid or flexible in its approach to emerging issues as the parties choose to make it.

A typical way of configuring parallel structures would be as follows i.e.

- Operational staff with frequent (possibly daily) contact
- Supervisory staff with weekly contact and problem resolution
- Management staff with formal reports, monthly meetings and a remit to review past performance
- Executive staff, with formal reports, quarterly meetings and a remit to review past performance and set the strategic direction of the contract.

This structure explicitly accommodates one of the key success elements of contract management i.e. the need for senior staff to be closely engaged with the contract. Implicit in this approach is also the need for monitoring to be done on a daily, weekly, monthly or quarterly basis for different aspects of each partnership, with the frequency often defined in the contract. It also allows for a public authority to use third party advice if needed.

The core approach to contract management is usually based on a model in which:

- The public authority defines the reporting needs
- The information used for monitoring is gathered by a combination of data provided by the supplier and that generated by the public authority's own independent monitoring activity<sup>225</sup>

- The data supplied by the private partner is subject to audit by the Contracting Authority
- The outcomes are assessed by the public authority and the conclusions shared with the supplier
- Where appropriate, corrective action is taken by the supplier,<sup>226</sup> the outcome of which is validated by the public authority
- Third party arbitration (possibly escalated through non-binding then binding arbitration) may be used by agreement where the parties cannot resolve a dispute by negotiation to avoid the ultimate resort to legal action (which generally represents an acceptance of breakdown in contractual relationships between the parties).

### ***Key contract monitoring issues***

Within this framework the key issues for a public authority are:

- **How to balance the sources for performance monitoring.** These will include, in addition to the monitoring the operational health and overall financial stability of the supplier (described above), sources such as trend analysis, immediate alert of critical failures, early warning alerts, use of end users, risk-based reliance on partner supplied data and a risk based structured approach to monitoring of performance by the contract monitoring team (described below)
- **The effective use of trend analysis.** Trend analysis can be used as a basis for investigating those matters which are due to factors beyond the control of the suppliers, either locally or nationally, and those which are due to declining or improving performance on the part of the suppliers. Trend analysis will also be important in assessing the credibility of the data generated by the supplier – i.e., by seeking to identify outcomes

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<sup>225</sup> Reliance on data generated by the supplier can reduce significantly the resource needed for the monitoring of service outcomes. It requires, of course, confidence by the Contracting Authority that the supplier’s information management systems are robust enough to generate data on which the Contracting Authority can place reliance and that actual transaction errors are not occurring. The processes described below follow the principles of systems and transaction audit and analytical review, including sampling techniques, which are well understood in an audit context.

<sup>226</sup> The emphasis here is also that the supplier i.e. the SPV is responsible for the delivery of the service, including that of sub-contractors, irrespective of how far risks have been passed through to them. An SPV should not be allowed to use sub-contractor failure as a reason for failure to deliver performance standards. Engagement of the Contracting Authority directly with sub-contractors, which can often seem to be practical at an operational level, particularly if there are difficulties arising, is one of the ways in which contractual risks transferred to the SPV can be passed back to the Contracting Authority. Thus such direct intervention should be resisted.



which represent a significant variation from earlier outcomes and determining whether they are in fact due to changes in performance or inaccurate data. This element of trend analysis will be particularly important if, as described above, significant reliance is to be placed, subject to audit, on performance data generated by the supplier. Measuring trends in performance over time also enables changes in performance to be measured and suppliers have the time to put improved procedures in place to achieve improved or sustained levels of performance over time

- **The effective use of a critical incidents procedure.** Not all failures by a supplier to achieve the required performance standards will be of equal importance. A power failure in a hospital has far greater significance than in a leisure complex or the temporary non-operation of one lane of a motorway. This is recognised by the fact that will be some events which, during regular operational monitoring, will merit an immediate default without opportunity for rectification.

Some events will, however, be more urgent than can be identified by regular operational monitoring. A contract monitoring regime should allow for immediate reporting of critical incidents such as failures resulting in breakdown of service delivery to customers and/or system overload breakdowns. While the occasional incidence of such events is not necessarily indicative of a failure by the supplier, an authority needs to be aware of them promptly to:

- Enable it to respond to any negative publicity which may result
- Ensure that the incident is properly and promptly investigated by the supplier
- Ensure that any immediate action needed has been taken
- **The use of early warning assessments.** It is possible for a Contracting Authority to identify potential early warning signs for contract failure. Such early warning signs could include:
  - Unexplained breakdown in management, administrative or operational systems
  - Unsatisfactory responses to matters raised at review meetings in respect of current developments within the supplier's business
  - Unfavourable variances in operational performance without satisfactory explanation
  - Failure by the supplier to take control action agreed at earlier review meetings
  - Evidence of significant inconsistencies or inaccuracies in the data generated by the supplier.

Evidence of the above signs could act as a trigger for closer operational monitoring i.e. for increased frequency and scope of monitoring. This is appropriate because poor operational performance is likely to be the first manifestation of future contract failure. These early warning signs can also indicate the need for more detailed discussion at a senior level with the supplier and for a more cautious approach to the acceptance of assurances from the supplier about future rectification actions

- **Structured use of end users in assisting with contract monitoring**, which could mean:
  - Using customer satisfaction measures amongst the performance measures
  - Requiring the supplier to maintain a log of user queries and complaints
  - Giving the supplier the first line of responsibility for fielding complaints, leaving the public authority with responsibility for following up unrectified complaints, which end users would be advised to direct to the central contract management team and auditing the supplier’s records of complaints as part of the audit of management information supplied
- **A risk based approach to monitoring of partner supplied data and to direct monitoring by the contract monitoring team** which, as noted above, will combine to make an assessment of supplier performance. It also unlikely to be effective to devote the same monitoring effort to all elements of the contract throughout the life of the contract, and the timing, frequency and intensity of contract monitoring is often linked to an analysis of the risk of service delivery failure. These risks are likely to vary between contract areas and service delivery points, and over the life of the contract.

Risk is normally judged on the basis of factors such as:

- Past performance of the supplier on the contract
- Environmental factors most critical to achievement of service delivery and/or most prone to failure e.g. particular services, particular end users or high profile services such as those in direct contact with external users and bearing in mind the relative value of the feature being monitored as compared to the cost of monitoring it
- The extent and nature of changes in service delivery, such as, for example, service delivery in areas forming part of the service enhancements arising from the implementation of the contract strategy, changes in supplier procedures, impact on continuing services at the time of the introduction of service enhancements, impact on core services of services newly offered by the supplier to third parties
- As noted elsewhere, the contract life cycle, where risk is likely to be

higher at the beginning and the end of the contract.

The risk factors for each service element and service delivery point are often weighted, with monitoring activities being aligned towards higher risks identified. Specifically, this means that there will be variation between the number of times individual service elements and service points will be monitored.

The risk assessment will, by definition, need to be subject to periodic review. The outcome of monitoring will determine if the original risk assessment remains appropriate. If the risk of service delivery failure for a service element and/or service point increases, the priority attached to monitoring will increase, whereas if the risk of service delivery failure reduces, the priority attached to monitoring will reduce. The benefit of this approach is that it redirects the monitoring effort towards the elements of service delivery which are at greatest risk of service delivery failure. It provides a framework within which the workload of contract management can be reduced without a reduction in the effectiveness of the monitoring that is carried out. It is an approach well tried and tested by auditors in carrying out audits of all types, including very large and complex audits

- **A structured approach to monitoring of partner supplied data and to direct monitoring by the contract monitoring team.** This is likely to include a planned programme of monitoring activity, monitoring independently of, or with minimum notice to, the supplier and monitoring which covers the continuing assessment of the supplier's operational, management and administrative systems, thereby providing the Authority with the continuing assurance that any reliance placed on the supplier's quality management systems and information systems continues to be justified. A breakdown in systems is likely to be followed by a future deterioration in the quality of service provided and may also be an early indication of contract failure.

It is also likely to include objective selection of features to be monitored, which calls for a definition of all the elements to be monitored and, in some cases, appropriate quality monitoring systems which select the number and nature of features to be monitored in any given monitoring event and which adjusts the sample size according to the supplier's track record i.e. tightens or loosens the monitoring according to performance.

The structured approach is best included in the contract management guide and should:

- Explain how the frequency of monitoring activity is related to different levels of risk of service failure

- Describe how monitoring activity should be undertaken, including such matters as the use of a checklist for monitoring activity, timing and recording of evidence to enable consistent judgements to be made over time and the desirability of recording and logging the basis for monitoring decisions where these are marginal
- Set out the standards expected including a clear, and as far as possible easily understood, definition of what constitutes a satisfactory and an unsatisfactory outcome of monitoring
- Be available to the supplier, who therefore knows what constitutes an acceptable standard for each feature and can identify the rectification time
- Set out how and when inspections should be reported to suppliers, including the need for immediate consolidation of findings after the visit, the contents of such reports, the nature of the rectification required – e.g. immediate (i.e. the supplier incurs an immediate default notice or penalty), within 24 hours, a week, a month, etc.

This will generally take the form of a report identifying areas in which the outcome of the inspection was satisfactory, areas in which it was not satisfactory, the overall assessment of the inspection (i.e. satisfactory or unsatisfactory), rectification action for areas deemed unsatisfactory and the timescale for it and control action proposed by the supplier where any unsatisfactory areas calls for a change in the supplier’s procedures. If there is rectification work to be undertaken by the supplier, the report needs to be prompt enough for both rectification and checking of rectification to be undertaken within the rectification target time

- Set out what follow-up action to take and the timing and conduct of such action, including the need to ensure that subsequent inspections promptly check on rectification and control action to be taken by the supplier, confirming that it has been implemented in the appropriate timescale
  - Set out how operational monitoring activity will be used as the basis for applying defaults and financial penalties in accordance with the contract conditions
- **Appropriate data collection and reporting mechanisms necessary to test whether or not performance targets are being achieved.** Timely performance reporting is likely to include, in addition to immediate data capture after undertaking quality monitoring and prompt reporting of the outcome of each monitoring event to the supplier:
    - A weekly summary of the outcome of monitoring activity by the contract monitoring team
    - Monthly reporting of performance against key measures to senior staff

in the Contracting Authority within two working days of the period end and, in some cases, monthly reporting of performance against key measures to end users

- Quarterly reporting of performance against key measures at executive level within three working days of the quarter end
- **Sufficient audit trail to check the accuracy of performance information.** Insofar as performance management of service delivery standards is based on the audit of performance data received from the supplier, it is essential that a Contracting Authority can rely on the accuracy of the data supplied.

There are generally four elements to this task, i.e.:

- Trend analysis, as described above
- Comparative checks of performance data. Contracting Authorities should be able to carry out periodic checks on the validity of the supplier-generated data by comparing the data with outside sources such as user information and other system generated information e.g. such as response time for calls to help desk
- Review of supplier systems i.e. to ensure that the data derives from systems which include controls which will identify and eliminate errors in the data. The review will need to be carried out near the beginning of the contract and then at agreed regular intervals after that, probably not less than twice per year
- Review of the arithmetic accuracy and internal consistency of data i.e. periodic audit of data received from suppliers to ensure its arithmetic accuracy and internal consistency.<sup>227</sup>

The key decisions needed to implement this approach are to define:

- The scope and frequency of comparative checks to be undertaken of performance data generated by the suppliers (transaction audit using external evidence)
- The procedures for review of supplier systems and the definition of the extent to which reliance can be placed on them to generate accurate

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<sup>227</sup> This could be done by taking a sample of inputs and outputs of data and tracking them through the supplier's system. This would include the arithmetic accuracy of output data that is summarised or used in supplementary or secondary systems and of any summarised input data. The internal consistency of data would be tracked through the systems in a similar way – i.e. ensuring that system outputs are consistent with what would have been expected given the inputs made. The systems established by the supplier must be capable of allowing for audit through all of these methods, hence the reason why, though much of the planning for contract management can be done at an early stage of the award procedure, it will be need to be finalised in the light of the systems used by the partner ultimately selected.

financial and operational data (systems audit)

- The scope and extent of the review of the arithmetic accuracy and internal consistency of performance data generated by the systems (transaction audit using internal evidence).

The review of supplier generated data will be based on an assessment of the risk of error in the data supplied. The outcome of the review will determine if the original assessment of the risk of error remains appropriate. If the risk of error increases the level of checking will increase, whereas if the risk of error reduces, the level of checking will reduce

- **Use of other appropriate means of value for money review.** These can include cost benchmarking of service delivery and investment plans against known current alternatives and the use of probity auditors to verify the accuracy of supplier generated information.

### ***Establishing an appropriate service planning regime***

This is most appropriately based around annual service planning and annual investment planning.

The annual service delivery planning places future delivery in the context of performance in the past year. In this context, it should report on the supplier’s past performance, approach to efficiency improvement, internal service reviews and future performance targets (including plans for any new activities and/or service enhancements). Dissemination of information within the annual plan for service delivery could be across the Contracting Authority, including end users.

The annual investment plan should report progress on implementation of the previous year’s schemes and show how the planned investment for the following year would be implemented. This would include detailed firm costings, timings and expected impact on performance standards for existing services/any new services. It would be reviewed at the senior executive level, including cost benchmarking against known current alternatives, assessment of functionality of proposed solutions, extent of variation from indicative cost and scope as compared to the original supplier bid for the contract or a previous plan and independent consultancy advice. The objective of the review is to ensure that service enhancements continue to represent value for money (which may mean, compared to the supplier’s original draft annual plan, at reduced cost and/or with different means of delivery and/or with enhanced performance standards).

## **Implementing an appropriate approach to change management**

Change management should cover the means by which changes to the contract are proposed, discussed, evaluated and implemented between the parties, both changes initiated by the public partner and by the private partner. They need to be managed effectively because – whether they are new services or changes in the standards, means of service delivery or payment mechanisms for existing services – invariably place the public sector in a weak bargaining position.

The approach to change management should generally specify:

- That both parties have a right to propose contract variations and in the case of the public partner an obligation to consider, but not necessarily accept, proposals from the private partner
- The format of such proposals, including a clear description of the impact on quality and volume of service, the impact on the customer's responsibilities, a measurement of the financial impact including the investment needed, the transitional revenue impact of any change net of any one-off income, the on-going current expenditure implications and an assessment of the impact on overall risk profile etc.
- Responsibility for preparing the detailed proposal, which will normally rest with the private partner
- The timetable for the process, which should be as prompt as is consistent with proper assessment of the proposal
- The approval procedure, in which, in the case of proposals from the private sector partner, the final decision will be made by the Contracting Authority, after a process of reviewing and challenging the private partner's proposal.

The detail required in the proposal will vary according to scope, value and complexity of the proposal i.e. a more detailed proposal will be required if the private partner is proposing to offer new services either to the Contracting Authority or to third parties, if the specific proposals have not been reflected in the annual service plan (see above) or if the change could potentially impact on the risk profile of the contract and/or the risk/return balance for the private partner.

In some cases a detailed business case/cost benefit analysis will be required, treating the proposal as being subject to the procedures for investment planning e.g. with reference to the objectives, evaluation criteria, financial capital investment, any contributions needed from the Contracting Authority i.e. people, physical assets, intellectual property assets, any income forecast, any expenditure implications for the Contracting Authority,

means of delivery, comparison with alternatives, cost benchmarking against alternatives, risk analysis/management, assessment of impact on existing services, impact on the performance management regime, manageability for the Contracting Authority and supplier etc.

The presumed objective of the challenge and review procedure would be that the existing private partner would deliver the change in full, but in a manner consistent with continuing value for money, which, again, may mean, compared to the supplier's original proposal, at reduced cost and/or with different means of delivery and/or with enhanced performance standards. Nevertheless it remains as an alternative, though one which is likely to reduce the attractiveness of the contract to the private partner, to define a different type of regime e.g. one in which the private partner was not guaranteed the award of 100% of contract variations, a condition which may or may not be linked to overall contract performance was not satisfactory.

In recognising that changes is likely to occur in a PPP contract, it is important that changes do not result in risks transferred in the procurement process, priced by the supplier and thus paid for by the public sector coming back to them.<sup>228</sup>

There may of course be circumstances in which the Contracting Authority might have to take back risks, which, for legitimate reason, the private partner can no longer accept. This could arise if the private partner which has accepted the risk chooses to manage it through insurance and the risk becomes uninsurable (such as, for example, insuring against the risk of terrorism, which became effectively uninsurable after September 11<sup>th</sup>). This also serves to highlight the fact that the circumstances in which the Contracting Authority should take back risks ought to be fairly rare, and should in parallel lead to an adjustment in the contract price for the risk no longer transferred.

## **Contract management and the contract lifecycle**

As noted above, different stages of the contract lifecycle call for variations in the approach to contract management.

The **transition phase** (the period between the signature of the contract and the start date), is likely to be resource intensive, and thus may call for

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<sup>228</sup> An example could be where the demand risk has been transferred to the private sector partner i.e. the payment is based on volume of service provided without an agreement to a minimum payment irrespective of volume. The demand risk would be transferred back to the public sector if there were a subsequent agreement to a minimum payment.



additional temporary resources. The key priorities for the Contracting Authority to address in this phase are to:

- Ensure that it does not start until the contract is signed, to avoid the risk that it might influence the negotiations
- Resist the temptation to re-open negotiations – this amounts to agreeing to an early contract variation
- Analyse and summarise the supplier's commitments, so that they are not lost either in the short or long term, especially as those who were initially involved in the delivery of what are long term contracts will cease to be involved at some point
- Ask the supplier for its transition plan i.e. a detailed timetable for the transition phase
- Mobilise the contract management team
- Test the performance reporting and information systems
- Not to forget to concentrate on the people factor if staff are transferring from the public authority to the new supplier i.e. the importance of managing the commitment of staff who are facing a transition in their working arrangements and are likely to be anxious about this change.

The **early implementation phase** (which, as noted above, in a PPP will have two elements i.e. the early construction phase and the early service delivery phase) will also be resource intensive, again calling for additional support to the core team.

The key priorities for the Contracting Authority to address in this phase are to:

- Implement the contract management structures described above
- Implement the reporting mechanisms described above
- Implement the change management mechanism described above
- Maintain a close dialogue with supplier to identify issues arising and to determine when to act and when to be tolerant of initial shortcomings, with the test being the seriousness of the impact on service users rather than any inconvenience to the Authority itself.

The **mature implementation phase**, which typically is classified as beginning 12-24 months (approximately) from start of the service delivery element of the contract. This is the phase in which procured value for money must be converted into delivered value for money.

Here the Contracting Authority's priorities will be to ensure that:

- Service delivery objectives are being met, aided by contract management information systems which are giving timely, accurate and relevant information with which to monitor the delivery of the contract

- The supplier is delivering on wider obligations/ “softer” targets such as any investment, employment and business development commitments
- The supplier is planning ahead for future service delivery, and that the Contracting Authority is giving the supplier enough information about its own future plans to enable the partner to plan effectively
- Sufficient thought, where appropriate, is being given to the renewal of the contract (e.g. when the Contracting Authority starts thinking about it, how it ensures that the current partner continues to provide the contracted service even if it will or may lose the contract, how it will communicate the information about a change of partner internally and externally, including with the current partner)
- There is a process to ensure that the lessons of the procurement process are recorded and learned by the organisation.



## CHAPTER 6

### PPP – Effective Audit

#### OVERVIEW

Previous chapters of this book have focused on the crucial role of public authorities in managing PPP programmes and in planning, procuring and managing PPP projects.

But, in most jurisdictions, the actions of public officials in the deployment of public expenditure in the delivery of public services are subject to third party scrutiny. Auditors are a key part of this process of public scrutiny and hence have a key role to play in monitoring decisions made in major procurements such as PPP.

There are several kinds of activity which fall within the definition of audit, including statutory external audit, internal audit, management audit and peer audit within an entity.

There are also other forms of procurement scrutiny, such as by national Parliamentary Committees, the European Commission and other European institutions, national procurement supervisory bodies, administrative tribunals and the courts in national legal systems, economic operators in markets, the media, politicians and wider civil society. These activities are important, because the health of an overall culture of monitoring the transparency, competitiveness, lawfulness and value for money is multi-faceted in a democratic society.

This chapter focuses on the role of external audit<sup>229</sup> because, put sim-

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<sup>229</sup> This is not to undervalue the important support role which internal auditors in particular can play if they have competence and resources to do so and have been given the remit to do so by an entity's management. They cannot replace the role of external auditors because they are not independent but they can play an important role in monitoring procurement e.g. in review of procurement systems and procedures, review of individual procurements and procurement categories, reviews of urgent issues in procurement and highlighting issues for the attention of the external auditors.

ply, external auditors are very well placed to undertake the role of scrutinising PPP because in most jurisdictions they are granted by statute powers of access to information, powers of reporting and in some cases powers to apply sanctions, the responsibility not merely to report on the regularity of expenditure discharged but also value for money in doing so and they are usually constituted so as to be independent of the entities on which they report.<sup>230</sup> For example, the head of the state audit service will normally be charged with reporting directly to the legislative arm of government (i.e. Parliament) rather than to the executive. In many cases they are the only organisation who can gain access to the often commercially confidential information necessary to assess value for money especially in the contract execution phase.

In addition to understanding the concept of value for money, one of the key stages in the development of the skills of an auditor is also to understand that procurement is not an end in itself but a means to achieving service delivery objectives. Hence effectiveness is one of the criteria for value for money in procurement i.e. whether or not a procurement supports the achievement of a service delivery objective.

The focus of this chapter is on the probity and value for money elements of the audit role which must be the overriding priority of external auditors.

This is often regarded negatively by Contracting Authorities, who are often prone to find the intervention of auditors in the PPP process as being unhelpful. Auditors have sometimes been unkindly described as those who “come in after the battle and bayonet the wounded” and as only being interested in finding mistakes. These are perhaps understandable reactions from public officials where there is a culture of fear that difficult judgments will be criticised in retrospect.

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<sup>230</sup> The author does not here intend to open the debate about how auditors maintain and demonstrate their independence from the bodies which they audit. This is an issue which, in the author’s experience, extends beyond the statutory duties and powers of auditors, the way they are appointed, the length of time for which they are appointed, the rotation of individuals responsible for the audit of an individual Contracting Authority and the availability of sufficient skilled personnel to undertake the audit, relevant though these are. At the heart of the issue of independence in auditing is the culture of the *auditing* entity i.e. whether or not those discharged with undertaking audits demonstrate actual independence of mind. Specifically, this means that when there is a difference of opinion with the Contracting Authority which cannot be resolved the auditors continue to assert their opinion (assuming it is justified) and are not culturally disposed to find imaginative ways of agreeing with the Contracting Authority’s view. This pattern of behaviour by an auditing entity is in the end the behaviour of individuals within the entity, who will, of course, respond to signals given about whether demonstrating genuine independence of mind is rewarded or discouraged.

But these are more a reflection of how PPP audits are conducted than necessarily a contradiction of the suggestion that audit of PPP procurements can have a constructive element in parallel with the custodian element of the role. Skilfully conducted PPP audit can also improve future practice, for example by highlighting good procurement practice, by supporting the well-managed risk taking and innovation in judgments by public officials and by highlighting lessons for the future, as most PPP, whether well or badly conducted, contain obvious and transferable lessons.

After setting out the key elements of the role of external auditors it then continues with an analysis of how these should be carried out and the key issues arising in the monitoring of both the management of national PPP programmes and in planning, procuring and managing PPP projects.

## **ROLE OF AUDITORS**

The role of auditors in monitoring major procurements such as PPP requires much of the same knowledge as is required by the public officials undertaking the implementation of PPP decisions. This requires that auditors need a good knowledge of public procurement legislation, of the decisions made by administrative tribunals and courts in public procurement cases (both nationally and at European level) and of the principles and practice of PPP set out in earlier parts of this book.<sup>231</sup>

In essence, the external auditor’s role in PPP is to ensure that:

- Territorial (i.e. national or regional) authorities manage PPP effectively in the context of an overall public investment programme and to bring individual schemes to market in a planned way<sup>232</sup>
- Contracting Authorities plan and conduct individual PPP projects deemed suitable for PPP within the investment programme in a way is in accordance with the law while exercising the judgments necessary to achieve value for money<sup>233</sup>
- Contracting Authorities apply the same considerations to managing the implementation of the PPP, including in particular of changes to the contract.<sup>234</sup>

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<sup>231</sup> The training of auditors is not designed to equip them to give legal advice to Contracting Authorities. But they need to be aware of the areas of legal risk for their audited entities and, as part of their process of assuring that there are proper arrangements for corporate governance, should ensure that the Contracting Authority has access to timely, skilled and robust legal advice in these areas of legal risk.

<sup>232</sup> See above, Chapter 2.

<sup>233</sup> See above, Chapters 3, 4 and 5.

The role thus embraces both programme management and project management aspects of PPP implementation and the contract award (planning and procurement) and management/execution phases.

This role is a very demanding one,<sup>235</sup> partly because, as argued above, external auditors are pivotally placed to discharge it. This is particularly true because there are relatively few examples so far of PPP schemes which have completed all of their design, construction and operational phases. So continuing interim assessment is needed, and in particular whether or not value for money secured during the procurement phase of a PPP is actually achieved when the PPP is delivered. Auditors are very well placed to undertake this assessment, and are very important to it, especially because of the relative scarcity of readily available data in the public domain about the effectiveness of PPP. This is likely to continue into the foreseeable future.

It is also demanding because, as noted above, PPP are long term, high value and often high profile transactions, sometimes surrounded with legal uncertainty<sup>236</sup> in an environment where there is a rising tide of public procurement related ECJ cases,<sup>237</sup> the likelihood of increased challenge to award procedures arising from *Alcatel Austria* case<sup>238</sup> and the increased risk of challenge to direct awards arising from the proposed changes to the Public Procurement Remedies Directive.<sup>239</sup>

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<sup>234</sup> See above, Chapter 5.

<sup>235</sup> This chapter is not intended to address in detail the issues associated with the creation of an appropriate framework of competence and ethical conduct amongst public officials, though these are crucial to compliance with the law and the achievement of value for money through transparent and competitive procurement. These include, for example, the existence of an established public service culture, the designation of a senior public servant in Contracting Authorities personally accountable to the legislature, an established and trained procurement cadre, a clear ethical code for the conduct of procurement backed by law, procedures, defining discretion, acceptable and unacceptable conduct in specific cases, legislation against fraud and corruption, effective and reliable operational and financial management information about procurement, and the clear designation of key staff able to commit public entities to contracts

Also crucial is the existence of a common understanding of the principles underpinning the conduct of public procurement procedures such as that:

- Effective public procurement is the key to effective use of state budgetary resources in the delivery of good quality public services to citizens
- Public procurement should be conducted by public bodies for the benefit of improving the quality of services delivered to citizens and not for the benefit of any individual stakeholder
- Effective public procurement relies upon the exercise of skilled judgement and discretion by public procurement officials and, as a result, cannot rely solely on following pre-determined procedures

Insofar as these are not givens, they add to the extent to which the role of the auditors is demanding.

A third reason why the role is demanding is that auditors can sometimes be called in at short notice with limited time to discharge the key judgement about whether or not to challenge the conduct of an award process.

This can happen after the decision to appoint a preferred supplier has been made in the negotiated procedure or the selection of the best offer in the competitive dialogue procedure though where there is effective communication between a Contracting Authority and its auditors this should not occur. The involvement of auditors in the award process at an earlier stage can have the benefit that there could be earlier identification of actions by the Contracting Authority which do not comply with public procurement or not lead to value for money, which may give the Contracting Authority to act correct these actions.

The risk for auditors to get involved at key milestones of the process is that they might be seen to be endorsing the process up to that stage and thus be used by the Contracting Authority to prop up the process. This is risky for auditors, firstly because information may subsequently come to light which was not known to the auditors at the time of the interim stage and secondly there may be a subsequent challenge to the process.

Thus auditors should make it clear than any interim review does not constitute a guarantee that a Contracting Authority will not receive a successful challenge from third parties to the contract award process, nor that they as auditors will not subsequently challenge the process or, using their statutory powers, to report publicly on any aspects of the process which do not represent value for money or are illegal.

Given the crucial role which external auditors have, it is to be expected that there would be some debate amongst the audit community about precisely what the limits of the procurement audit role are i.e. what lies outside the role, even where auditors are given a wide remit to audit value for money as part of the discharge of accounts. But it is generally accepted that the role of an external auditor in auditing a PPP would not include:

- Assessing the appropriateness of a decision made by a Contracting Authority to use or not use PPP, or any form of third party service delivery, for a particular project

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<sup>236</sup> Such as over which legal rules apply i.e. public contract or concession, how a procurement should be conducted if full regulation in the Public Procurement Directives does not apply, such as for Part B services or concessions, how the Competitive Dialogue will work in practice consistent with the principles of equality and confidentiality and how the Public Procurement rules apply to Institutional PPP.

<sup>237</sup> See above, note 135.

<sup>238</sup> See above, p. 83.

<sup>239</sup> *Ibid.*



- Assessing the validity of the policy objectives and priorities of a Contracting Authority
- Assessing the validity of the objectives set by a Contracting Authority for a procurement.

This would only be subject to review if in any of these areas the actions of the Contracting Authority were illegal i.e. if the Contracting Authority is exceeding its statutory powers or contravening some specific legislative provision, such as for example if the failure to use a PPP would lead it to be unable to comply with a legally compliant budget.

## **OPERATIONAL APPROACH TO PPP AUDIT**

The operational approach to PPP audit comprises three elements, namely:

- The scope of the PPP audit process
- How to set priorities for the PPP audit role i.e. which transactions to audit and how to focus activity within them
- How the role can be discharged effectively

### **The scope of the PPP audit process**

As noted above, the potential scope of the PPP audit process is, subject to the limitations explained, as wide as the decision making process of the Contracting Authority.

In the context of a specific PPP, the audit covers the whole procurement process i.e. including the needs analysis/link to the Contracting Authority's service objectives, market assessment, contract strategy, advertisement/information for interested parties, short listing of candidates, preparation of the award stage (which could be for the restricted, competitive dialogue or negotiated procedure), dialogue/negotiations with short listed entities, offer evaluation, post offer evaluation activity<sup>240</sup> and post award activity<sup>241</sup> in addition to the contract management phase.

But as in all other kinds of audit activity, it is neither necessary nor desirable for the external auditor to audit all aspects of all transactions, and,

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<sup>240</sup> Such as the specification, clarification and fine tuning of offers permitted in the competitive dialogue procedure.

<sup>241</sup> Such as the clarification and confirmation of commitments in the winning offer permitted in the competitive dialogue procedure.

indeed, to do so would risk diversion from proper attention being given and resources directed to the high risk areas.<sup>242</sup> This is vital because not all procurement activity justifies or can receive the same audit attention – the key is for auditors to focus on what matters most.<sup>243</sup>

Hence the importance for the auditors of setting priorities for their audit activities, which will be based on consideration of the procurement activities carried out by all of the Contracting Authorities for which they are responsible and, at an individual Contracting Authority, its past and prospective procurement activity<sup>244</sup> as reflected in its annual procurement plan. For the body responsible for the discharge of the central government’s accounts, this means the management of the overall public investment programme, all of the procurements carried out or planned to be carried out by central government and, if the logic of territorial PPP management is followed, by all Contracting Authorities.

### **Setting priorities for procurement audit**

Auditors will typically need to take account of three considerations<sup>245</sup> in assessing how to prioritise their procurement i.e.:

- Which Contracting Authorities to prioritise
- Which procurements to prioritise<sup>246</sup>
- Which elements of the procurement award and management process to prioritise.

These priorities will be set according to the risks attaching to each factor i.e. the risk that the Contracting Authority will fail to conduct the award procedure in a transparent and competitive way (thus putting the achievement

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<sup>242</sup> Planning PPP audit thus needs, of course, resources to be available at the appropriate time, which pre-supposes that the timing of audit interventions is itself planned.

<sup>243</sup> The concept of risk based auditing is well understood by auditors trained in financial regularity audit.

<sup>244</sup> This book is not a detailed text on the conduct of audit activity in general but auditors in general will recognise the concept that the scope of audit should be both retrospective and forward looking.

<sup>245</sup> This is not, strictly, a hierarchy of priorities, in the sense that the auditors will prioritise *in that sequence* Contracting Authorities, the high risk procurements undertaken by high risk authorities and then high risk activities in those high risk procurements. The result of the overall planning assessment may very well be that auditors concentrate their procurement audit activity on a small number of Contracting Authorities and procurements.

<sup>246</sup> Since PPP are long term, high value and in some cases novel projects, it is very likely that a large number of PPP will merit scrutiny by the auditors.

of value for money at risk) in compliance with the law and/or fail to manage the implementation of the project so as to ensure that value for money achieved in the award process is realised in the contract execution.

### ***Prioritising Contracting Authorities***

The need for focus by Contracting Authorities is important because individual procurements are not conducted in a vacuum – they are conducted by people within a framework of corporate governance within an organisation which will embrace policy objectives and priorities and means of achieving them and a set of operating procedures which will implement those priorities. These operating procedures will express both the competencies of the Contracting Authority and its norms of ethical behaviour.

Procurement is also a constant activity for public bodies i.e. they will have conducted procurements in the past which will give auditors information relevant to the risks associated with its procurements.

In the context of assessing the risks set out above which are associated with a Contracting Authority, the auditors will therefore need to take account of considerations such as:

- **The track record of the Contracting Authority in procurements**, where the factors which would tend to suggest that there are higher risks include a past record of a absence of sufficient planning, evidence of having been unduly influenced in contract award procedures by encirclement, significant number of past successful legal challenges to procurements, excessive use of the negotiated procedure, particularly without publication of a contract notice, on grounds which *prima facie* do not appear to be robust, use of inappropriate timetables for procurements, actual experience in realising procured value for money (including evidence that the Contracting Authority has accepted back risks transferred and paid for in the award process), frequent cancellation of procurements with apparently little justification, lack of interest in/competition for contracts leading to failed procurements, long periods of negotiations with a preferred bidder in a single tender environment, evidence of acceptance of supplier driven solutions, evidence of contracts signed on terms unduly favourable to suppliers or with above average profit margins for suppliers especially if not related to the value of risks transferred, high levels of contract variations/differences between contract prices and actual prices, frequent contract extensions with apparently little justification, absence of market making/review of market offerings, problems in transition or early delivery, failure to establish effective contract management arrangements, failure to enforce contract terms and use of insufficiently skilled third party procurement

advisers

- **The governance of the Contracting Authority** where the factors which would tend to suggest that there are higher risks include the capability of senior staff and political leadership, a bullying style of leadership with limited respect for public procurement law, where authority is concentrated in one/few people, absence of an appropriately resourced and empowered internal audit function, reluctance to co-operate with external auditor/the auditors’ need to invoke legal right to documents, evidence of lack of respect or of coordinated action between officials and political leaders and/or the absence of political opposition
- **The attitude of the Contracting Authority to PPP**, where the factors which would tend to suggest that there are higher risks include the existence of an ideological attitude to PPP, where there is a tendency to suggest that “there is no alternative” to PPP, where there is a tendency to be dismissive of past experiences, and where PPP have been used in circumstances where, even after taking into account the valuation of risks transferred, the case for doing so is marginal
- **The current operating environment of the Contracting Authority**, where the factors which would tend to suggest that there are higher risks include budgetary difficulties, statements which commit political reputations to the completion of projects, pre-announced deadlines for the completion of procurements, lack of procurement skills/evidence of skills development, lack of attention to high value/difficult procurements, too close relationships with service providers and the response to legal challenges (i.e. whether or not they are taken seriously)
- **The clarity, transparency and effectiveness of the Contracting Authority’s operating procedures**, clearly setting out the decision making processes (including the supervisory procedures), the responsibilities for undertaking them, the competencies needed for specific tasks (which may include training and/or professional qualifications or certification) and the internal controls to prevent error or malpractice.

No single one of these factors means, *per se*, that an investment programme or an individual procurement will not be implemented in a way which delivers value for money and is compliant with the law. But the more factors which are present the greater risk that they might, though of course the judgment of the auditors will also have to take account of the intensity of the factor.

### ***Prioritising procurements***

The second layer of priority which auditors need to apply in deploying their resources is to prioritise procurements, because, just as the risk posed by different Contracting Authorities is not equal, so some procurements represent higher risk than others. As noted above, since PPP are long term, high value and in some cases novel projects, it is very likely that a large number of PPP will merit scrutiny by the auditors.

Some of the factors referred to above in the context of assessing the risks associated with a Contracting Authority will also apply to the prioritisation of procurements e.g. those factors relating to past procurements may very well be relevant to procurements which form part of the current audit planning cycle.

In addition, the auditors will also need to take account of two main types of consideration i.e. those which are inherent in the procurement itself and those which relate to the outcome of the procurement as seen by third parties.

- The risks inherent in the procurement fall into three main categories i.e.
- **Those relating to the nature of the award procedure**, where higher risk can be expected to attach to procurements have been directly awarded or awarded using the negotiated procedure (because of the need for very specific justification and the risk of third party challenge), awarded using the Competitive Dialogue procedure (because of the uncertainty associated with both the novelty of the procedure and the exercise of discretion by Contracting Authorities which may lead to third party challenge), designated as works or services concessions (because of the less prescriptive rules laid down for them in the Public Procurement Directives), those which may be classed as private initiative PPP (because of the greater risk of lack of competition inherent in such PPP) and where the award procedure has been directly related to the political cycle i.e. with the contract being signed just before an election
  - **Those relating to the subject matter of the procurement** where higher risk can be expected to attach to procurements which relate to Part B services (again because of the less prescriptive rules laid down for them in the Public Procurement Directives), contracts in sectors or services which have a track record of past delivery difficulties (IT contracts in the UK, construction contracts in many countries), are technically complex contracts such works in difficult terrain, are novel contracts, e.g. services not previously contracted for using a PPP or are contracts of an exceptionally long duration, which in a PPP context could mean anything more than 35 years

- **Those relating to the private sector partner which the Contracting Authority has selected**, where higher risk can be expected to attach to procurements where the private partner is a consortium where a significant ownership is held by a financial institution (which may not have public service delivery as its core mission) and/or by a non-national owner (which may not be committed to public service delivery in a particular territory), which does not seem to be appropriately matched to the needs of the Contracting Authority (i.e. is too large, too small, potentially not committed to the market sector, potentially financially unsound, potentially not technically capable of delivering and/or has looked for early re-negotiation of contract), has based the viability of its business plan on ambitious projections for third party income and/or has not applied appropriate sensitivity analysis in the business plan.

As noted above, auditors are not and cannot be only guardians of legality and value for money in procurements and should therefore due note of the actions taken in respect of procurements by third parties. These relate to both processes which were challenged by participants in the process and those where concerns have been raised by other third parties such as the media and wider civil society such as non-governmental organisations (NGOs).<sup>247</sup>

As regards the case of challenges by participants in the process, the audit function exists in parallel with the administrative and/or judicial remedies available to participants and should not allow themselves to be used as a substitute for the pursuit of such remedies by disaffected losers.<sup>248</sup>

Thus when there is a challenge to a PPP process the auditors need to understand the challenge, assess its significance i.e. assess the effect of the matter complained about on the award decision, decide if there was a prima facie case to answer (i.e. that the complaint was timely and relevant, made by a complainant who had the legal right to complain and not obviously frivolous or malicious) and review how the complaint was dealt with by Contracting Authority, including its decision, and if appropriate the decision made by the administrative tribunal or the courts.

It is essential to note that the opinion of third parties should not be the decisive factor in determining whether or not an auditor should investigate a procurement, still less can they be bound it. This is particularly true of those

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<sup>247</sup> The Public Procurement Remedies Directives are so framed as to confer rights on those with an interest in the outcome of a contract award procedure (see Art 1 of the Remedies Directive). Those who do not have such an interest, i.e. those who did not participate or could not have had an interest in delivering a contract, do not have the *locus standi* to use the Remedies Directive to challenge award procedures.

who are not participants in the process and thus have no access to legal remedies. While auditors on the one hand should not discourage the role played by civil society in countering fraud, corruption and waste and should encourage vigilance, on the other hand they need to be aware of the potential risk of falling into the “pressure group trap” of acting as the advocates of a particular interest group.

### ***Prioritising high risk elements of the process***

The third layer of priority which auditors need to apply in deploying their resources is to prioritise the high risk elements of the procurement process, which in this context embraces both the contract award and contract execution phases.

Many of the issues which are high risk within a procurement and call for complex and often difficult judgements by a Contracting Authority have already been highlighted earlier, such as the dialogue, post offer and post tender phase of Competitive Dialogue, the preferred bidder negotiation phase in the negotiated procedure, the transition and early delivery period of contract execution, the need to manage contract variations and contract break points effectively, the judgements made by the Contracting Authority in key areas of the contract conditions, the importance of ensuring that the Contracting Authority does not award a contract materially different from

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<sup>248</sup> It remains a relevant question for debate whether or not auditors might in fact become part of the process of administrative review of PPP, especially in Member States which have exercised the option available in the Remedies Directive only to offer judicial remedies. The concept of remedies in the Public Procurement Directives itself is based on the principle that the prime movers for action should be those with an economic interest in the outcome of a procurement. The European Commission, for example, does not have the resources to investigate more than a small proportion of alleged infringements. The desirability of this concept of remedies is in particular advanced by those who favour the availability only of judicial remedies. As demonstrated in the UK, which has taken the option only to offer judicial remedies, this means that in practice very few cases exist of remedies being sought because of the cost, protracted nature and uncertainty of judicial proceedings. An alternative approach is that of more proactive monitoring to ensure that the Public Procurement Directives are complied with. This role could be undertaken by national public procurement supervisory authorities working in conjunction with the national PPP authorities. This alternative appears to accept a shift of responsibility and costs for investigating infringements of the Public Procurement Directives from the private sector to the state, though, of course, the use of supervisory authorities would not prevent actions by participants in the process. There are, of course, costs to the public sector associated with the creation of such a supervisory authority but, if the potential savings highlighted by the Commission (see above, note 10) can be replicated across the spectrum of public procurement activity, then it should be possible to make the case for such a supervisory authority on cost-benefit as well as conceptual grounds.

that which was advertised (thus risking legal challenge) and that the Contracting Authority has well defined exit strategy for the contract. Similarly, the way in which a Contracting Authority actually applies the offer evaluation criteria is by definition a critical area.

In the author’s experience a long period of post offer negotiations poses particular risks, such as that:

- The winning bidder may seek to introduce qualifications and conditions associated with matters included in their proposal which it said were guaranteed
- Even where a Contracting Authority is in a position where it has the option not to reach an agreement with a provider i.e. because it is not compelled to by its financial position and/or current service delivery standards, the momentum of the negotiations and the time invested in the process to date may lead to a deal being struck which does not represent the minimum gains necessary to justify the new arrangements as value for money
- If the Contracting Authority does not reach an agreement during negotiations with the potential provider, then, irrespective of which party ultimately withdraws from the negotiations, it may be difficult in future for that authority to generate market interest in a subsequent contract letting process.<sup>249</sup>

The auditor also needs however to pay particular attention to the risks associated matters which may be extraneous to the control of the Contracting Authority such as debt refinancing, change of ownership/trading of stakes and step-in by lenders to replace sub-contractors and service providers.

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<sup>249</sup> The strategy for managing these risks could involve, in addition to an appropriate negotiating strategy in place for negotiations:

- Requiring confirmation from the winning bidder as a condition of selection that they will enter into a negotiating protocol in which they agree to be bound by the terms of their offer where these are not stated to be conditional, to commit sufficient resources to the final stages of the negotiation, to be bound by the agreed negotiating timetable and to ensure that those negotiating have the authority to commit the winning bidder
- Determining what it regards as the overall minimum acceptable outcome for the negotiation
- Determining what it would regard as an unacceptable outcome from the negotiations e.g. the type of conditions proposed by the winning bidders associated with the key contractual issues, maximum acceptable scope of variations from the proposal etc.



## **Effective procurement audit**

Having made decisions about the priorities for procurement audit, the effective implementation of the procurement audit process will normally follow an approach common to other types of audit. This will typically include the following steps i.e. to:

- Establish the decision made by the Contracting Authority
- Establish the audit trail i.e. the process by which the decision was made, including identifying key documents, people making the decisions and the context within which the decisions were made
- Follow the decision making process from start to finish, using a structured approach for each stage
- Form a judgement about the process, the award decision and the execution of award decision
- Determining how, if at all, to report on the decision made.

The judgement which the auditor makes in the context of a procurement decision will be related to the matters noted above i.e. the extent to which the actions taken are lawful, have been determined in accordance with the principles of probity and value for money and have been properly implemented i.e. that the correct amounts of public funds have been actually paid at the right time to the private partner in return for the contractually agreed services.

In coming to these judgments, the auditors will need to bear in mind that their role is not necessarily to second guess the decision making process of the Contracting Authority i.e. the fact that the auditor can envisage a different way of conducting the process is not in itself a sufficient ground for challenge.

Many of the issues arising can, at least at an initial level of enquiry, be captured within a common framework and are thus capable of being approached using a checklist for each element of the process i.e. programme management, contract award and contract management.

### ***Programme management***

In forming a judgment about the effectiveness of assessing the management of an investment programme, auditors will of course take account of the limitations on the scope of the auditor's role set out above i.e. those relating to the use or not of PPP and of the validity of policy objectives.

But they will be able to audit the implementation of an investment programme which includes PPP programme, in which they will need taking account of the matters which the Contracting Authority itself will have con-

sidered in implementing the programmes. These are set out in detail above in Chapter 2 but in summary include consideration of whether or not:

- A multi-annual investment programme for major investments across government and sub-national authorities was properly developed and prioritised
- Projects in the programme potentially suitable for PPP have been identified on a case by case basis
- A proper assessment has been made of the public authority’s own capacity to commission a PPP effectively and manage the resultant transaction, the supply market’s ability to bid for and deliver the objectives of the PPP and the optimal timing of the procurement process
- The Contracting Authority has maintained up to date knowledge of supply markets, financial markets and demand by other public bodies and has made use of this information in implementing its procurement decisions in such a way as to remain in control of supply markets
- The Contracting Authority has implemented review mechanisms for its investment programme and individual procurements within it.

### ***Contract award***

Consideration of all the matters set out above in Chapter 5 in relation to the planning of a PPP<sup>250</sup> will be relevant to the auditors when auditing the contract award element of the procurement process.

Thus they will in practice be likely to ask such questions as:

- Was there a proper market assessment in advance of the decision to launch a procurement?
- Is there a well justified needs assessment of the need for the investment? (e.g. meet but not exceed user needs, reduce prices/improve quality, deliver new services etc.)
- Is PPP the appropriate route to achieve the Contracting Authority’s objectives?
- Is the financing structure appropriate to the nature of the contract and the Contracting Authority’s objectives?
- Are these objectives clearly identified and reflected in the contract offered?
- Did the contract offered reflect the outcome of the market assessment by the Contracting Authority and its own needs assessment?
- Was the contract strategy formulated and implemented in a way appropriate to the needs of the Contracting Authority?
- Was the procurement award process well justified as the best route to

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<sup>250</sup> See above, p. 110 *et seq.*

achieve the objectives of the procurement, including through update of the PSC at different stages of the award process and particularly after the receipt of offers and just before financial close?

- Is there any evidence that the contract structure has been unduly influenced by the desire to keep the transaction off-balance sheet, as opposed to by value for money considerations?
- Was the award process used properly justified (if necessary) on a firm legal basis?
- Did the contract notice accurately describe the opportunity?
- Was the contract widely advertised?
- Was the information provided to interested parties accurate?
- Was the information provided to interested parties compliant with the minimum required by the law?
- Was there any additional information which could have been given to attract appropriate potential suppliers and deter the inappropriate potential suppliers (to avoid wasting their and the Contracting Authority's time)
- Was the deadline for the submission of applications appropriate to the size and nature of the procurement?
- Did the Contracting Authority entity establish transparent, non-discriminatory selection criteria and means of assessing requests to participate?
- Did the Contracting Authority receive sufficient credible expressions of interest from potentially capable suppliers?
- Were the selection criteria appropriate to the procurement?
- Were the minimum levels of financial, economic and technical capability for the criteria appropriate to the procurement?
- Did they actually apply these criteria as planned?
- Were the reasons for the composition of the short list clear, comprehensible and prima facie justifiable?
- To what extent did the Contracting Authority discuss the shape of the call for offers with the selected bidders?
- In the case of a procurement using the Competitive Dialogue procedure, did the Contracting Authority have a clearly defined and appropriate strategy for the matters which are not defined in detail in the Public Procurement Directive?
- Was the call for offers prepared in a way which maximised competition and minimised the risk of extended post offer negotiations?
- Was the information provided in the call for offers accurate?
- Was the information provided to bidders in the above documents compliant with the minimum required by the law?
- Was there any additional information which could have been given to

improve the quality of bids made and encourage bidders to bid?

- Did the Contracting Authority maintain equality of treatment in the provision of information to bidders? (particularly during the dialogue phase of the Competitive Dialogue procedure)
- Was the deadline for the submission of bids appropriate to the size and nature of the procurement?
- Did the Contracting Authority establish transparent, non-discriminatory and appropriately the weighted evaluation criteria and means of assessing offers? (e.g. guidance to scoring of offers)
- Did the Contracting Authority actually receive credible and competitive offers from the short listed suppliers which met their service objectives?
- Was the Contracting Authority clear about what information it wanted from bidders and in what form?
- Was this information requested in a form which made it easy for offers to be assessed?
- Did they actually apply the evaluation criteria as planned?
- Did the final award decision take proper account of any financial, commercial and technical risks inherent in the different offers made?
- Is the winning bid sustainable? i.e. based on financial and operational projections which are based on sound assumptions
- Were the reasons for the final award decision clear, comprehensible and prima facie justifiable?
- Did the Contracting Authority have an appropriate negotiating strategy in place for negotiations? (which will include an assessment of the Contracting Authority’s position on key issues, the risks inherent in a long period of single tender negotiations with the winning bidder and a risk management strategy)
- Did it follow the strategy?
- Did the strategy achieve its objectives both in the negotiations and, where appropriate, during the life of the contract?
- Have all the issues identified at the time of submission of offers been resolved?
- Have the negotiations resulted in contract terms which materially vary from the offer at tender stage and thus may be open to challenge because the Contracting Authority proposes to agree to contract terms which:
  - Are materially less favourable than included in the tender, and
  - If originally proposed in the offer by the private sector partner could have resulted in the selection of a different bidder?
- Was the contract finally awarded after negotiations consistent with the contract advertised?
- Were there any contract terms which are unduly favourable to suppliers?

(e.g. asset transfers at undervalue, performance standards, lax monitoring regime, weak penalty clauses, difficulty of termination, compensation on termination etc.)

- Does the contract require improved supplier performance over the contract's life?
- Have the administrative and legal formalities of contract award been properly complied with?

### ***Contract management***

Consideration of all the matters set out above in Chapter 5 in relation to the management of a PPP<sup>251</sup> will be relevant to the auditors when auditing the contract award element of the procurement process.

Thus they will in practice be likely to ask such questions as:

- Did the Contracting Authority have appropriately resourced and skilled contract management and monitoring arrangements in place at the time of contract award?
- How was the transition phase dealt with i.e. preparations for execution i.e. after contract award and before start of contract performance?
- Were there any major early problems in contract performance?
- Are the service delivery objectives being met?
- Is the supplier delivering on all service obligations?
- Are senior staff at the Contracting Authority sufficiently engaged with the contract?
- Is there a competent, empowered and sufficiently resourced contract management structure?
- Is management and monitoring information about contract performance being collected, reported and acted on?
- What role do end users play in managing and monitoring the contract?
- Is the Contracting Authority giving the supplier enough information about future plans?
- Is the supplier actually planning ahead for future service delivery?
- Are payments being processed properly?
- Are payments made in accordance with the contract?
- Is there proper justification for any post-award changes in the contract terms?
- How has the Contracting Authority ensured that it has secured value for money in changes to the contract terms?
- Have any risks transferred to suppliers in the contract structure been transferred back to the Contracting Authority?

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<sup>251</sup> See above, p. 123 *et seq.*

- Has the Contracting Authority actually enforced the contract terms when necessary e.g. re invoking penalty clauses, termination etc.?
- Have the lessons of the procurement process been noted and learned by the Contracting Authority?
- What plans are being made for the re-tendering of the contract?
- Is procured value for money being converted into realised value for money?

### ***Reporting on PPP audit***

In reporting on a PPP audit the auditors will be guided by their statutory powers and responsibilities, including their reporting powers.

In general, these may include, depending on the nature of the matters uncovered,<sup>252</sup> reporting to the executive management of the Contracting Authority, reporting to the Board of the Contracting Authority (which may include both executive and non-executive members), reporting publicly and/or initiating a legal challenge to the actions proposed or taken by the Contracting Authority. This latter option would normally exercised only in cases of serious failure of outcome and process by the Contracting Authority.

PPP audit reports can play a significant role in assessing the implementation of a PPP. This was highlighted in the case of one of the largest and most complex PPP in Europe i.e. the London Underground PPP, which was controversial during its implementation, and was the subject of a legal challenge to the government decision to proceed with the PPP by the Mayor of London.

The UK NAO report into this transaction<sup>253</sup> played an important role in highlighting the issues raised by the PPP.

Some of their specific findings were that:

- “These are complicated deals, worth a great amount of money and spanning a long period into the future”
- “In the face of the inevitable uncertainty about what the next 30 years will bring, only time will tell whether these prospects are fully realised and, therefore, whether the eventual price that the taxpayer pays is worth it.”
- “(There is) limited assurance that the price of the three Tube PPP was reasonable”
- “The deals offer the prospect, but not the certainty, that improvements

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<sup>252</sup> See also above, pp. 146-147. The concept of an auditors report should not always be construed negatively, though, in terms of their statutory responsibility, their intervention is often in circumstances which lead to a negative report.

<sup>253</sup> See above, note 29.

- will be delivered”
- “(There is) some uncertainty about the eventual price although any price revisions have to meet tests of economy and efficiency”
- “The terms of the deals changed markedly during prolonged negotiations with the eventual winning bidders... prices all rose, adding £590 million to the 30 year cost of the deals”
- “If (the suppliers) deliver performance at bid levels private sector shareholders stand to receive nominal returns of 18-20 per cent a year. This is about a third higher than on recent PFI deals
- “If the private companies achieve the lower performance levels set by benchmarks, their real returns would be between 10 and 17 per cent a year”
- “Work will start two years later than originally planned”
- “Recovering the maintenance backlog is now expected to take over 22 years rather than the 15 years originally intended”
- “(It is) hard to determine whether the benchmarks are easy or difficult to achieve”
- “In the first year, the performance of the companies against their contractual targets has been mixed, but in line with what the private companies forecast in their bids”
- “The price, scope and funding of the PPP are reviewed every 7½ years and so could change”
- “Oversight mechanisms require good flows of information from the (private sector partners) about how they are progressing with asset capability and condition improvement projects”

This highlights the difficulty of forecasting service needs over long periods, the potential difficulty of maintaining value for money across break points, the risks of separating infrastructure and service provision, the weakness of a Contracting Authority in single tender negotiations, and the impact of contract size on competition (i.e. for very large contracts it was inevitable that offers could only come from consortia).

How to address any potential process failures of unsatisfactory outcomes is far from being an easy judgment for auditors i.e. when to act and when not to act, at least in respect of the value for money aspects of their assessment.<sup>254</sup> In this respect they will need to consider not just the outcome of the decisions made by the Contracting Authority but also whether or not the process was reasonably likely to have delivered value for money.

Put simply, the process may have been designed effectively even though

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<sup>254</sup> There is clearly very much less flexibility in respect of potential breaches of the law.

it did not result in the desired outcome. Thus auditors may be less inclined to judge unfavourably Contracting Authorities where they have, for example:

- Given most attention to high value/high risk procurements
- Devoted sufficient time and appropriate resources to planning major procurements
- Taken active but unsuccessful steps to promote competition (e.g. desk research, discussion with potential suppliers, knowledge sharing with other Contracting Authorities etc.)
- Advertised an opportunity widely
- Maximised information given to interested parties/bidders
- Clearly recorded the reasons for decisions taken
- Been open about complaints received by participants in the process and investigated them seriously.

These are not of themselves decisive in influencing an auditor’s approach but are indications to help auditors come to their judgements about which Contracting Authorities deserve support for their approach to major procurements and which need to improve their processes.





## CHAPTER 7

### Reforming PPP in Europe – Conclusions

#### OVERVIEW

The experience of PPP, as reflected in the key ideas of this book, leads to the conclusion that the legal framework and practical application of PPP are in need of change. The conclusions in this section have implications for the public sector (both at a political and operational level), private sector service providers and lenders.

The main aim of the proposed changes is to develop a more comprehensible legal framework for PPP in Europe as much if not more driven as far as possible by legislative choice rather than judicial evolution (i.e. by legislation rather than by case law) and a better coordinated and more market aware approach to the implementation of PPP by the public sector at both European and national level.

These aims are grounded in the importance of greater legal certainty to long term, high value transactions such as PPP and by evidence that transparent and competitive procurement appropriate to the significance of the transaction is the most effective way to achieve the overriding objective of PPP in Europe i.e. the implementation of the service delivery objectives of public entities at all levels of administration (and EU policies and legislation) in a manner likely to promote value for money.

From a European perspective, administrations cannot afford anything less, since without it the funding gap<sup>255</sup> i.e. the gap between the financing needed to implement the European policies and the public funds available to be filled by private finance would become even greater than it is currently

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<sup>255</sup> There is a serious responsibility on the part of EU legislators to address this issue when passing EU law i.e. in conducting an impact assessment of the cost of new legislation not merely to assess the cost of implementation but also in identifying how it will be financed.

projected to be. At national level the same considerations apply to territorial entities aiming to implement new investment programmes to improve service delivery.

The main conclusions in this section are also underpinned by a number of other key ideas i.e. that:

- PPP are sometimes but not always the right means for achieving value for money in public service delivery
- Very few PPP have gone the full course of their life. The claim that PPP have already delivered value for money savings is by definition based on savings achieved in the award process and/or savings achieved during the asset construction phase. A better test of value for money is one made over the whole life of the transaction, for which new performance indicators are needed
- The test of when PPP should be used should be pragmatic not ideological i.e. that PPP should not be the default option for a public investment project but properly assessed on a case by case basis
- PPP are a form of public procurement, so their application should be undertaken within the context of the Public Procurement Directives. No useful purpose is served, either in terms of improving legal certainty for PPP or in obtaining value for money from them, by creating additional legal forms for PPP transactions separate from those defined in the Public Procurement Directives and, indeed, that further consolidation of the award processes would be desirable, reducing the scope for opportunities to avoid transparency and competition in procurement in the way that the contract is structured. Other changes such as a separate EU legal framework for PPP in general or for concessions would not achieve this effect and indeed risk encouraging “regime shopping”
- The effects of the changes in the legal framework are as far as possible best brought about by legislative choice rather than judicial evolution i.e. by legislation rather than by case law
- Since PPP in essence are a form of long term, high value and often complex public procurement, the application of effective investment programme and project management and good public procurement practice will go a long way towards success in the implementation of PPP
- Bidders are more likely to bid if they know that they can obtain redress if things do go wrong in a procurement process and understand the process for obtaining redress. The Public Procurement Remedies Directive needs to be effective in removing barriers to cross-border bidding
- Competitive Dialogue, the new award procedure introduced in the latest Public Procurement Directives, has the potential to make the use of PPP easier but needs to be applied with great skill and care by Contracting

- Authorities and needs greater clarification about how it should be used
- There is insufficient clarity for Contracting Authorities about what changes to the original contract are and are not permitted in the contract execution phase. Greater clarity would be desirable in order to define what constitutes permissible change
  - If the public sector does not control the market for PPP, then service providers and lenders will control it – to do this requires better coordinated, appropriately resourced, well-informed, active and skilled market management by the public sector at all levels, using the power which public authorities have as buyers in many markets, bringing schemes to market in such a way and at such a time as to maximise competition
  - Because of the high level of activity, Member States need a mechanism to allow themselves to step back to review how PPP programmes and individual projects are achieving their planned objectives, and also to look at the medium and long term effect of PPP on public service delivery
  - The current market model for PPP enables private sector service providers to enter the market who regard PPP contracts as short-term tradable financial instruments and not as a long-term commitment for public sector service delivery
  - PPP has the potential to lead to major change (much higher intensity) in the role of the private sector as a service deliverer. Where the public sector has withdrawn substantially or completely as a service provider there can be difficulties in some cases for public entities to regulate the sector effectively. Thus the public sector should actively promote a mix of different models of service delivery – including direct service provision, contractual PPP and institutional PPP – to maintain its own capacity. This will help the public sector to retain policy choice and an effective exit strategy should this be necessary
  - No public authority wishing to enter into a PPP should forget that there will be no transaction unless the private sector partner can make a profit commensurate to the risks it is assuming and lenders are willing to lend to the private sector partner if the transaction is being privately financed
  - PPP is likely to continue to be relevant service delivery in Europe for the foreseeable future and the fact that important decisions are being made now which will impact on public services in Europe over the next 25 years or more. Thus politicians and public officials in the EU have responsibility, on grounds of intergenerational equity, to ensure that decisions taken now do not adversely impact upon future taxpayers and service users in respect of affordability, fiscal risk and maintaining public sector control over policy choices. Short term political expediency

- should not compromise overall value for money
- A PPP is a contractual agreement between the public and private partners. Therefore, the rights and responsibilities of both parties should be set out as clearly and definitively as possible in the contract documentation
  - Value for money for the public sector is most likely to be achieved if it initially fixes the terms of the contract while bidders are subject to competitive pressures. Further guidance is needed to reinforce the intention of the Competitive Dialogue procedure, which is to minimise the extent to which changes are made to the contract after tenders have been submitted and even more so after the selection of the winning tender
  - If the public sector wishes to change the terms of a PPP, it is likely that there will be a cost involved, particularly as, after the award of the contract, these changes will be made in single tender negotiations. Hence PPP are more suitable for services where the outputs of the contract can be specified with sufficient precision and are sustainable i.e. the extent to which, and the period for which, a service is “contractible”
  - The valuation of risks transferred to the private sector often determines whether or not a PPP represents value for money as compared to the alternatives. Thus it is crucial for the public sector to decide how it wishes to distribute risks between the parties, taking into account who is best placed to bear them and the value it places on the risks transferred. The public sector should not pay for the transfer of risks when, if they materialise, they will in reality be transferred back because the public sector cannot accept the consequences of service delivery interruption
  - It is necessary for Contracting Authorities to ensure that sufficient time and skilled resources are devoted to planning a PPP before the commencement of the procurement process and to the management of PPP contracts once awarded
  - External auditors have the powers, the independence and in many cases the skills to review both the procurement process and the realisation of value for money in the delivery phase. Indeed, they are often the only parties which have access to information necessary to assess value for money but their role is currently under-recognised and under-developed.

The conclusions set out the main areas in which reforms are proposed and bring together the various threads developed in detail earlier in the book. They set out the actions to be taken at EU level, national level and by Contracting Authorities.<sup>256</sup>

## **ACTIONS AT EUROPEAN LEVEL**

The proposed actions at European level fall into four categories i.e.

- Changing EU legislation
- More effective enforcement of EU legislation
- Better definition of the existing legal framework
- Establishment of a European PPP agency.

### **Changing EU legislation**

There are three key proposals for changes to European legislation, which, since PPP are a form of public procurement, relate to amendments to the EU Public Procurement Directives i.e.:

- The standardisation of the award procedures for all types of public contracts and concessions within the Public Procurement Directive, since there is very little justification for the differences between procedures applicable to different types of transaction and benefits from standardisation of the procedures (**see page 79**)
- Bringing service concessions within the scope of the Public Procurement Directive, and thus also within the scope of the Public Procurement Remedies Directive, because, as Commission says, it is “difficult to understand why service concessions which are often used for complex and high value projects are entirely excluded from EU secondary legislation” (**see page 79**)
- Reviewing the status of certain less regulated (Part B) services, with a view to reclassifying them as Part A (fully regulated) services but which are now increasingly being provided through PPP and attracting cross-border bidding, thus recognising that they are now relevant to the completion of the EU Internal Market. (**see page 73**).

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<sup>256</sup> By way of personal explanation the author does not regard these ideas as necessarily either indivisible or mutually exclusive. Nor does his experience of the European legislative process and national decision making lead him to believe that this is anything other than an ambitious agenda for change which will take time to be realised. But he is of the firm conviction that, because of the likely continuing relevance of PPP to future service delivery in Europe and the fact that important decisions are being made now which will impact on public services in Europe over the next 25 years or more, this is the right moment to start the process of change in order to maximise the impact of these ideas on how PPP is implemented over time.

## More effective enforcement of EU legislation

Because of their high value PPP have the potential to attract Europe-wide competition. But, as noted above, bidders are more likely to bid if they know that they can obtain redress if things do go wrong in a procurement process and understand the process for obtaining redress. The European Commission has referred to the unsatisfactory situation brought about by the diversity of national review procedures. The current updating of the Remedies Directives provides an opportunity to reduce this diversity.

In addition to enacting the proposals included the draft amended Remedies Directives for standstill periods between contract award and contract conclusion, some other areas in which greater clarity and a reduction in diversity would be desirable include: (see page 84)

- Specifying the procedural rules applicable to reviews, such as the requirement for administrative and judicial review bodies and the access to relevant information and documents by the aggrieved party
- Determining what the plaintiff has to prove when seeking damages e.g. the likelihood that they would have won the contract or that they might have won the contract and how this might be done
- Standardising the basis on which damages are calculated. Currently there can be different bases of valuation e.g. loss of profits, bidding costs incurred, some element of opportunity cost etc.<sup>257</sup>

## Better definition of the existing legal framework

There are three areas in which further technical guidance from the Commission would be desirable, including:

- In the Competitive Dialogue procedure, guidance on the conduct of the dialogue phase both to develop good practice and to identify precisely how a Contracting Authority can comply with principles of confidentiality, equality of treatment and non-discrimination, thus minimising the risk of legal challenge and also to develop a model of how to achieve value for money (see page 89)

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<sup>257</sup> In making these recommendations the author is fully aware of the extent to which their implementation would require an agreement by Member States to accept the effect of Community law in national legal systems in a way which extends the current competence of Community law.

- In the Competitive Dialogue procedure, a definition of what is permissible in the context of “clarifying, specifying and fine tuning” tenders after the receipt of final tenders and “clarifying aspects of the (winning) tender” and “confirming commitments contained in the (winning) tender” after the selection of the winning tender. The key to achieving value for money in major contracts is maintaining competition as close as possible to contract signature. Good practice, not always followed, has always been that the selection of winning tender should not happen until all substantial terms and conditions affecting the price and delivery of a project have been settled while there is still competition. A tighter definition of what is and is not permitted would act to counter any tendency to interpret the procedure as permitting the continuation of the current practice of substantial negotiations in a single tender environment with the winning bidder (**see page 92**)
- A definition of what constitutes permissible change to the contract terms in the contract execution period without the need to re-tender the contract. This should determine, in particular, in what circumstances the sale of ownership of equity stakes in PPP projects to third parties and debt refinancing by equity shareholders constitute permissible change. Again, this could act to minimise possible breaches of the principle of equality of treatment between tenderers. (**see page 99**).

### **Establishment of a European PPP agency**

The current and likely future importance of PPP for the development of infrastructure in the EU, the scale of the investment needed and the relative weakness (arising from fragmentation) of the public sector as compared to the private sector when awarding PPP contracts means there is a need at European and national level to manage PPP in the context of an overall public investment programme and to bring individual schemes to market in a planned way.

At a European level, this means that it would be desirable to create a European PPP agency (**see page 51**) to supervise the implementation of PPP projects in defined sectors which have a European policy dimensions (such as TENs projects) and which are above a given value. This agency would also be responsible for matters such as advice on the legal framework, advice on the financing implications of new legislation, review of other major schemes implemented by Member States and assessment of medium and long term issues such as affordability, fiscal risk and maintaining public sector control over policy choices in Member States.



More generally, the influence of a European PPP agency could be brought to bear on the changes (described below) which are needed to the PPP market model.

## **ACTIONS AT NATIONAL LEVEL**

The proposed actions at national level fall into five categories i.e.

- Controlling the PPP market
- Changing the PPP model
- Clear measurement of performance in the contract execution phase
- An enhanced role for auditors
- Continue to improve the national legal framework for PPP.

### **Controlling the PPP market**

There is a need to bring about equality of power between on the one hand the public sector and on the other both the large and increasingly globalising and consolidating private sector service providers and the predominant influence currently exercised over PPP by lenders.

There are four key proposals for enhancing the control which the public sector has over the PPP market i.e.:

- More effective co-ordination and review at national level i.e. creating an appropriately resourced, and skilled central PPP unit with the remit to actively manage the PPP element of the government's investment programme, thus maximising the control which the state exercises over the market (**see page 35**)
- A conscious decision to deliver investment projects by a planned mix of service delivery models i.e. a mixed market between public provision (which may include variants such as public-public co-operation and shared service provision), IPPP and contractual PPP, with the transparent and competitive application of the Public Procurement Directives in the selection of partners in the case of IPPP (**see page 47**)
- A conscious decision to deliver investment projects by a planned mix of financing models i.e. a mixed market between privately financed, mixed public-private financed and publicly financed PPP<sup>258</sup> (**see page 44**)
- The development of a limited range of standard model contracts for different models of PPP in key sectors with less customisation and the need for national approval for variation from them. (**see page 38**).

## **Changing the PPP model**

The actions necessary to change the market model are, in some respects the most important steps which need to be taken to change the way in which PPP are implemented in Europe. They cannot be achieved without a conscious decision to actively manage markets as set out above.

The need for the changes arises from the fact that, in several respects, the current market model is unduly unfavourable to the public sector. These include the involvement of lenders only at a very late stage of the transaction (i.e. when the preferred bidder/winning tenderer has been identified), the length of contracts (which makes it difficult to subject the arrangement to periodic competitive pressure), the cost of changing contract terms in a single tender environment and the termination arrangements to compensate lenders where there is failure by the service provider. (see pages 55-66).

The situation has arisen because the current market model for PPP has evolved through practice rather than being based a prior analysis of the approach which best accords primacy to the public sector’s aim for whole-life value for money in the achievement of its service delivery objectives and assesses the true nature of the risk being accepted by private sector partners and lenders by the principal parties to the transaction (i.e. the SPV and the senior lenders as opposed to sub-contractors). The public sector also failed to anticipate the evolution of the PPP market in certain key ways such as the development of secondary markets in PPP stakes and debt re-financing.

Several specific factors, not all present in all cases, have driven the acceptance of this market model. They include, for example, the budgetary, legislative and service pressures on public authorities, lack of active market management of the kind advocated above, and, in effect, what may be characterised as a quasi-ideological preference for the private financing of PPP combined with public political commitments to investment made independently of consideration of the need to manage the award of a PPP in a way

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<sup>258</sup> This may include an expansion of the Credit Guarantee Finance option, which the UK government has sought to pilot. This is, in essence, a publicly funded PPP in which the government lends to the SPV at market rate and secures the repayment of the debt by insuring its repayment, for example through a monoline insurer for the payment of a fee. It in effect transfers the repayment risk to the insurer. In pure financial terms the government saves the difference between the government costs of borrowing and the market rate, less the insurance fee. But it also means that government steps into the transaction with the influence lenders have, and, in particular, avoids the cost of a termination payment to a private sector lender in the event of the early termination of the contract through failure of the SPV to deliver the service. Of course it itself bears any loss arising from the failure and inherits a part-completed contract which it can then competitively re-tender.

calculated to secure value for money for the public sector.

This has led to some service providers and lenders, knowing that significant investment commitments requiring private finance have been made and thus that there will be many bidding opportunities, being able both to select the most profitable opportunities and to seek more favourable terms in delivering them.

Thus the case for re-assessing the market model is compelling, particularly because of the growth in the use of PPP across a wider range of services and the fact that important decisions are being made now for long-term commitments which will impact on public services in Europe over the next 25 years or more.

Three key ideas underpin the proposed changes.

**Firstly**, the proposed changes are based on the idea that PPP should represent stable long-term commitments to the delivery of public services over the whole life of the contract by both partners, not just by the public sector.

Entry into a PPP should not be regarded as short-term tradable financial instruments, and, insofar as they are by some service providers,<sup>259</sup> the public sector should consider whether such partners are suitable for engagement in PPP. Thus there would be parity of commitment between the public and private partners, which would work to the advantage of those investors and lenders, such as the EIB, who do regard participation in a PPP as a long-term commitment. Such an expectation of commitment is no greater than that given by private sector partners in major outsourcing contracts so they should not be unfamiliar to them.

**Secondly**, the Contracting Authority will have based its decision to short list a bidder on the basis of qualification criteria and then, when awarding the contract, taken account of the appropriateness and sustainability of its offer.<sup>260</sup> Integral to this is the overall management of the construction of the asset and the delivery of the service by the lead members of the consortium. Thus the Contracting Authority cannot be neutral about changes in ownership of stakes. Put simply, the ownership of the entity changes the basis of the decision made by the Contracting Authority, may impact on how the service is delivered and potentially undermine the synergy of PPP i.e. that the best way to optimise the efficiency of design, construction, operation and maintenance of the asset is if the private partner responsible for

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<sup>259</sup> According to the UK NAO, share ownership of PFIs has changed in 40% of cases (“Update on PFI refinancing and PFI equity market”, Report of the Comptroller and Auditor-General, HC 1040, Session 2005-2006, 21 April 2006, p. 29.

<sup>260</sup> This is entirely separate from any issues associated with the breach of the principle of equality of treatment which may arise if debt refinancing and/or sale of equity stakes were to be regarded as fundamental changes to the contract.

design and construction of the asset is then required to operate and maintain it for a fixed price.

**Thirdly**, there is the need to maintain accountability. Some of the interest in acquisition of stakes comes from private equity funds for which, by definition, since they are not listed on capital markets, there is less transparency than for listed companies. The proposed change in respect of sale of equity stakes would help the public sector to restrict any possible limitation on accountability.

There are several potential elements to a changed market model.

### ***Aligning the length of PPP contracts more closely with the public policy planning horizon***

Consideration should be given to shortening the length of **public service** PPP contracts with a view to limiting them to the reasonably foreseeable planning horizon for public policy. This will vary from sector to sector but there are few services where needs will not change significantly over, say, a 12-15 period so that generally the length of the operational period of PPP contracts should be limited to 15 years, after which the Contracting Authority could reconsider the service provision options.<sup>261,262</sup>

At the end of the contract period the Contracting Authority would either:

- Acquire the asset at nil value, with an obligation on the service provider to maintain it to a given standard and return it in a fit for purpose condition without payment at the end of the contract and with a post contract warranty (for, say, two years)
- Acquire the asset at an independently determined market value from the service provider at that time, taking into account the age and condition of the asset and its expected future economic life and either operate the service itself or retender an investment, operation and maintenance contract, adapted to its changing needs.<sup>263</sup>

This approach would in effect detach the length of the contract from the economic life of the asset and:

- Allow the Contracting Authority to test value for money through re-tendering at the end of each contract period
- Still allow the service provider a sufficiently long period to implement

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<sup>261</sup> In determining the length of contract the European Commission has pointed out that “the duration of the partner relationship must be set so that it does not limit open competition beyond what is required to ensure that the investment is paid off and there is a reasonable return on invested capital”. See *the PPP Green Paper*, p. 15.

<sup>262</sup> The proposed model thus has some similarities to the PPP FM leasing model used in Germany and described in Button, *op cit*, p. 121.

efficiencies in operations and exploit the economic benefit of owning the asset

- Include a sufficiently long period of service provision to realise the design, construction, operation and maintenance synergies which lie at the heart of the commercial logic of PPP
- Ensure that the service provider was motivated to maintain the asset to an appropriate standard, thus giving the Contracting Authority the assurance that it will recover the asset in a fit for purpose state at the end of the contract
- Assure the lenders of the security of their loan in that it will be repaid either during the life of the contract or by the end of contract payment for the asset, assuming that the service provider has delivered the service and maintained the asset in a fit for purpose state.

### ***Initial financing of a PPP***

Proposals to be considered would include:

- Requiring that the share of financing provided by equity shareholders in PPP projects is greater than is often currently made (10%-15% in many cases) and is at least at a minimum defined level such that they represent

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<sup>263</sup> The author is aware of the objection that a limitation on contract length could lead to an increase in the monthly periodic charge proposed by the bidders (in net present value terms) because of the shorter period over which the debt principal and interest will be repaid and the investors earn their return. This may happen if it is intended that the assets transfer back to the Contracting Authority at nil value at the end of the contract or service providers/lenders still wish to bid on the basis that they wish to achieve their return on investment/loan repayment during the initial contract period. But if the assets transfer to the Contracting Authority at the then current market value at the end of the contract, this approach should not materially affect the amount of the periodic charge, since the service provider will receive that value as a lump sum at the end of the contract. In most cases the asset will have a value either because either the service will continue to be needed or the land on which the asset is constructed will have a value, though of course, if bids are made on that basis, both public and private partners are taking some risk on the accuracy of the forecast of the end of contract value. The effect on the periodic charge may in any case be reduced if investors are willing to accept a lower rate of return than has generally been the case, or can enhance their operational efficiency gains. The fact that they might do so in some mature sectors is indicated by the lower rate of return already accepted by secondary investors in PPP schemes. More active management of the PPP market, as advocated above, will also exercise competitive pressure on rates of return for service providers. An increase in the net present value of the PPP option will make it relatively less attractive than other options and may lead to more PPP not passing the PSC.

As noted above (see note 24), the decision about the basis of the end of contract asset transfer would have to be made at the time of awarding the contract, because, in the second case, the end of contract payment would form part of the overall receipts of the service provider.

a real investment commitment by the equity shareholders and a greater cushion against loss before the project is at risk of default to its lenders

- Setting a maximum for the equity share which can be held by financial institutions as opposed to construction or service provider partners.

### ***Reducing the scope for single tender negotiations with winning bidders in PPP***

Bidders should be required to submit tenders, irrespective of the award procedure, with committed finance from lenders on terms acceptable to the Contracting Authority. This avoids the situation when, after the selection of the preferred bidder or winning tenderer, and the removal of competition, the Contracting Authority may be faced with a series of new negotiating points raised by the lenders. This would mean in practice that lenders would need to play an active part in the dialogue phase of Competitive Dialogue procedure so that their needs can form part of the overall contract negotiations prior to final tenders being submitted.<sup>264</sup>

### ***Improving the stability of PPP financing***

The commitment of investors, and hence the stability of financing for PPP, would be enhanced if changes in equity stakes or debt of a PPP project become exceptional transactions requiring the prior approval of the central PPP unit and were permitted only in specifically defined circumstances, with the burden of proof resting on the applicant for approval.<sup>265</sup>

This would apply to:

- The sale of ownership of equity stakes in PPP projects by the original owners to third parties (i.e. not the Contracting Authority or another public entity) generally, including to other Consortium members<sup>266</sup>
- Debt re-financing by the original owners of equity stakes in PPP projects.

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<sup>264</sup> The argument against involving funders early is that of higher bid costs for bidders but, by ensuring the commitment of funders while there is still competition for the contract, there is likely to be less scope for post offer variations to the contract terms which are unfavourable to the Contracting Authority.

<sup>265</sup> The UK NAO recently highlighted the linkage between sales of equity stakes and debt refinancing in that there had been a change of investors in 40% of UK PFI projects and in 50% of these cases there had also been a debt refinancing, as compared to 25% when there had not been a share sale. See “Update on PFI debt refinancing and PFI equity market”, Report of the Comptroller and Auditor-General, HC 1040, Session 2005-2006, 21 April 2006, p. 30.

<sup>266</sup> The argument is sometimes advanced that the rotation of equity stakes generates capital taxation revenues for the national exchequer. But the benefit of this does not, in the author’s view, outweigh the advantages of stability of service delivery, parity of commitment and accountability advanced above.

As regards the sale or transfer<sup>267</sup> of ownership of equity stakes (or the beneficial rights in shares<sup>268</sup>) in PPP projects,<sup>269</sup> these would be not be permitted in the first eight years after financial close, except where:

- It is at the direction of the Contracting Authority on the grounds of failure to deliver the service specified, or
- It is strictly necessary to maintain the overall solvency of the shareholder and only then after recourse to the shareholder's other assets to maintain its commitments under the contract.

Thereafter, it would be permitted where, in addition:

- The sale occurs no earlier than the mid-point of the original contract, and
- The purchaser undertakes to retain the stake until the end of the contract, and
- The sale is to an entity which is a service provider and which meets the qualification criteria set out by the Contracting Authority in the original award procedure more closely than any interested party excluded during the short listing procedure, and
- The purchaser does not fall into any of the categories defined by the Contracting Authority as unsuitable at the time of the award of the contract (e.g. that stakes in health PPPs are not sold to alcohol and tobacco companies), and
- The purchaser commits itself not to participating in debt re-financing in a period of five years following the change of ownership of the stake, and
- The contractual responsibilities of the seller under the original contract are novated to the purchaser.

As regards debt re-financing by the original owners of equity stakes in PPP projects, this would be not be permitted in the first eight years after financial close, except where it is strictly necessary to maintain the overall

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<sup>267</sup> It is necessary to refer to the *transfer* of shares to prevent the objectives of the restriction being avoided by transfer of shares to a new vehicle by the owner – often to create a PPP stake portfolio – which is then sold.

<sup>268</sup> Again, the reference is needed for anti-avoidance purposes i.e. to prevent the sale of the economic rights in shares e.g. rights to dividends and distributions without the sale of the shares themselves.

<sup>269</sup> The fact that such anti-avoidance qualifications are necessary is, in the author's view, clear evidence of the extent of the issue which these proposals are trying to address i.e. the idea that PPP are mere financial transactions and not a commitment to long term service delivery.

solvency of the shareholder and only then after recourse to the shareholder’s other assets to maintain its commitments under the contract.

Thereafter, it would be permitted where, in addition:

- The re-financing occurs no earlier than the mid-point of the original contract, and
- An appropriate share of the benefits of the re-financing are either:
  - Passed to the Contracting Authority immediately, or
  - Placed in a special reserve to be distributed between the equity investors and the Contracting Authority at the end of the contract, and
- It does not result in an increase in the Contracting Authority’s termination liabilities or any other financial obligations under the contract, and
- It does not result in an increase in the length of the contract, and
- It does not result in a change in other terms of the contract.

***Greater equity for the Contracting Authority where there is default by the service provider***

The following procedure should be standard where there is default by the service provider which is deemed to merit the termination of the contract:

- The senior lender should be empowered and required to find a suitable alternative service provider within a reasonable agreed period i.e. one who meets the minimum original qualification criteria more closely than any interested party excluded during the short listing procedure and is thus acceptable to the Contracting Authority and subject to the novation (unchanged) to the new service provider of the terms of the project agreement, including acceptance of the residual obligations of the loan advanced by the lender. In effect the new service provider would fully replace the old one and the repayment of the loan would rely on the revenues from the project generated by the new service provider
- If they do not or cannot do so, the Contracting Authority should have the right either to terminate the contract, recover the assets and either:
  - Run a new tendering procedure, which comes with an obligation to adhere to the terms of the original service contract and original loan with the lender, which would transfer to the new service provider. The public sector would run the service in the interim
  - Take over the provision of the service themselves.

In the event that the new tender process is unsuccessful, or the Contracting Authority chooses to take over the provision of the service themselves, the termination liabilities payable to lenders in the event of the termination of a PPP contract arising from service failure on the part of the SPV should be capped at an agreed pre-determined percentage of the lower of the total



amount payable to lenders under the terms of loan at the time of default and the value of the project assets at the time of default. This percentage would be set at a level which does not act as a deterrent to Contracting Authorities who wish, after due process and on reasonable grounds, to terminate a contract. It should also be set so that the prospect of significant loss would act as a real incentive for lenders to proactively manage the performance of the service provider or find a suitable replacement.<sup>270</sup>

Contracting Authorities should also use this approach in a mixed finance PPP where some of the finance is provided by them.

Taken together, these measures would clearly make the market less liquid and therefore less attractive to some investors and lenders. In particular it would restrict the development of secondary markets through the sale of stakes to infrastructure funds, though not, of course, opportunities to act as primary investors in bid consortia. But all the current evidence is that the demand for infrastructure assets and the appetite of lenders to lend is very high, so it is not likely that they would seriously compromise the availability of private finance for those public authorities who wanted or needed to use it to finance infrastructure. Some of these financial investors are, for example, driven by the need for secure, long term sources of income to fund pension liabilities. The investors and lenders who remained in the market would be doing so with a greater degree of long term commitment.<sup>271</sup>

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<sup>270</sup> It would clearly be very helpful to the implementation of these recommendations if the EIB, which has a public mission, could set an example by accepting them as the norm in PPP contracts, after, of course, requiring Contracting Authorities to be very rigorous in their assessment of the risks of the project. In this way the EIB could help to shape the market and help to ensure that they became standard practice.

<sup>271</sup> The author is conscious of the argument that such measures need to be considered in the context of Article 56 of the EC Treaty, prohibiting restrictions on free movement of capital. But it is worth noting that even in the case of privatisation (and thus *a fortiori* to less reversible forms of private sector intervention in service delivery), the Commission has clarified (See Press Release IP/01/872, 20 June 2001) that Member States may apply conditions to the subsequent sale of shares as long as such conditions:

- Are based on specific economic policy objectives and are clearly defined beforehand
- Are applied without discrimination
- Are limited to the time necessary to achieve the specific objectives
- Leave no margin for interpretation by the administrative body responsible

Any conditions attached to sales of stakes and refinancing need, of course, to be made explicit to all participants in the process at the time that the contract is advertised to ensure compliance with the principles of equality of treatment, non-discrimination and transparency.

The proposed measures are capable of meeting these conditions, based as they are on the economic policy of the pursuit of value for money objectives and the need for accountability, parity of commitment to service delivery and need for market management set out above to help achieve it.

## **Clear measurement of performance in the contract execution phase**

The designation of certain key indicators to judge the performance of PPP at both national level and at the level of individual Contracting Authorities would allow for measurement of how PPP is being implemented.

These measures should include:

- The number and value of contract changes during the execution of the contract proposed by the Contracting Authority
- The number and value of contract changes during the execution of the contract proposed by the service provider
- The increase in project cost between the selection of the preferred bidder/winning tenderer and contract close
- The real (constant price) increase in cost of the contract over its life, analysed by five year segments
- The real (constant price) increase in cost of the contract before and after contract break points
- The percentage of quarters in which the service provider fully achieves performance standards
- The number of service failure points incurred by the service provider as a percentage of the total number of service points available
- The value of financial penalties imposed on the service provider as a percentage of the total contract value
- The actual return on equity capital invested in the project as compared to the rate projected at the time of the contract award.

In addition, the transparent measurements of fiscal risk disclosure as advocated by the IMF should be adopted. (see page 64).

## **Enhanced role for auditors**

External auditors have the powers, the independence, the access to information (often uniquely) and, potentially, the skills to review both the procurement process and the realisation of value for money in the delivery phase.

Thus auditors have a pivotal role in evaluating the implementation of both the contract award and contract execution phases of PPP. This role should be recognised and enhanced by empowerment (such as a right of access by auditors of public bodies to the records of private sector partners relevant to the PPP and the practical enforcement of the obligation by Contracting Authorities to co-operate with auditors) and an enhanced responsibility to audit PPP transactions, based on the types of prioritisation set out

above. (see pages 151-157).

Contracting authorities should also be obliged to obtain the opinion of their auditors on the following matters relating to value for money i.e.:

- An independent valuation at the time of the contract award of the risks transferred in a PPP, given their importance often in determining whether or not a PPP represents value for money from the perspective of the public sector, and their relationship to the projected returns of shareholders
- Whether or not any events in the period between the selection of the winning bidder and financial close mean that the PPP no longer represents value for money from the perspective of the public sector
- An annual assessment of whether or not the PPP continues to represent value for money from the perspective of the public sector
- A comparative assessment of performance of the SPV in delivering the contract against other similar contracts.

Taken together, these measures would mean that auditors become a second means of assuring value for money for the public sector to reinforce appropriate procurement methods and effective contract management.

### **Continue to improve the national legal framework for PPP**

This could include:

- Continuing to remove administrative and legal barriers to PPP, including barriers particular to civil law jurisdictions (see page 17)
- Declining to introduce sectoral or sub-national legislation or different award procedures for PPP. (see page 79).

### **ACTIONS BY CONTRACTING AUTHORITIES**

Contracting Authorities can enhance the effectiveness of the implementation of PPP by ensuring that they:

- Recognise the importance of time and resources to plan PPP transactions and devoting sufficient resources to management of PPP contracts to ensure that value for money achieved in the award stage of the process is actually realised in its execution (see pages 110-122)
- Set selection and evaluation criteria for contracts such that there is clarity in the short listing process about the experience and qualifications which the applicant is relying on, and, at the award stage, who will

deliver which elements of the service. This will enable Contracting Authorities to form a judgement about the acceptability of any future changes in the identity of service providers or the investors in the PPP (see page 60)

- Determine, before the award process starts, a minimum percentage advantage that the PPP option should demonstrate in the PSC in order to become the preferred option to counter the lock-in factor, the complexity factor and the uncertainty factor associated with PPP. It will, in effect, be set at a level to seek to ensure that PPP still remains value for money over the life of the contract even if the terms of the contract deteriorate from the point of view of the Contracting Authority (see page 65)
- Adopt an approach to Competitive Dialogue which tends as far as possible towards an investigative approach to rather than a consultative approach i.e. that the dialogue phase is only launched when the Contracting Authority has a clear understanding of the likely solutions to meet their needs and the strengths and weaknesses of those solutions. Wherever possible the dialogue should be based on a solution or solutions already developed by the Contracting Authority and launched by them as their preferred solution at the opening of the dialogue phase (see page 92)
- For contract variations, provide a guarantee to the service provider for only part of any additional services required under the contract (as opposed to increased payments arising from demand variations), with the non-guaranteed element being competitively tendered by the service provider and other providers. Tendering is likely to be more effective than benchmarking as a means of exercising competitive pressure on service providers. (see pages 58 and 141).

## **END PIECE**

These proposals will lead to a transfer of powers upwards between the local, regional, national and European tiers of government. But the need to bring about equality of power between on the one hand the public sector and on the other both the large and increasingly globalising and consolidating private sector service providers and the predominant influence currently exercised over PPP by lenders, is the overriding argument for many of these proposals. Put simply, if the public sector does not control the market for PPP, then service providers and lenders will control it. It is difficult to see how this equality of power can be achieved if decisions about PPP are sub-

stantially devolved below national level.

As a result, some of the proposals, insofar as they seek to rebalance the relationship between the public and private partners may be opposed by some private sector service providers and by lenders, and thus there is limited value in allowing stakeholder opinions to be definitive in determining how to act. What is relevant here is not what stakeholders say they will do but what they actually do when faced with opportunities to participate in award processes. Hence there is a sense in which the change agenda needs political will to change the rules of the market and the will to act at a level which will command the attention of the market. Not all national administrations will be able to implement all of these ideas because of their dependence on private finance and there is a risk that if some Member States seek to change the market model in isolation they may find it relatively more difficult to raise private finance where they need to than others who do not or cannot act to change the model. Hence the need for actions both at national and European level.

Finally, as has been made clear on several occasions in this book, this does not constitute a philosophical opposition to PPP or private financing of them, but merely to ensure that they are used on a basis which enhances value for money for the public sector.