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Private Public Partnership (PPP) Finance: An Alternative to State Budget Funding

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1. BACKGROUND: NEED FOR SUSTAINABLE PUBLIC SECTOR FINANCE

There is a worldwide need for public-sector project finance: infrastructure, healthcare, water, sewage, energy, oil and gas pipelines, seaports, airports, railways and roads have to be financed. In order to maintain sustainable public debt levels internationally, tapping private finance sources is essential. In this environment, Private Public Partnership ("PPP") finance is taken into consideration as a global alternative to state budget funding. The basic principle of PPP finance is "off-state budget" finance:

- providing public-sector assets or projects as collateral or underlying for private sector funding;
- using the income streams generated by such public-sector assets or projects for payments to private sector fund providers; and
- while at the same time avoiding government borrowing and indebtedness by using private-sector vehicle companies (SPVs).

This is why Private Public Partnership finance is already a multi-billion business in Europe and elsewhere — interestingly, to a large extent with the exception of the USA, due to the use of tax-exempt municipal bonds. Just to mention a few examples:

- Toll roads in Austria (Asfinag), France and Italy; in Germany, 6 projects at € 5.1bn have been completed, with another 7 projects (€ 6.1bn) in the pipeline, and an additional 10 projects earmarked for PPP.
- A great deal of the French super-regional hospital centres and university clinics are financed using PPP.
- Sport centres and stadiums, such as the Paris Omnisports Complex.
- Education, such as the University of Lille.
- Office parks such as Paris Parc du Millénaire, housing the French ministry of the interior.
- Seaports and airports- in Berlin, e.g., private-sector participations in the capital airport are under consideration. Approx. 500 airports worldwide have some form of private-sector participation. A few companies such as Fraport participating in related PPPs are listed.

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- In Germany, a national committee mandated by the Federal Ministry of Economics and Technology has made far-reaching proposals in respect of financing future infrastructure need using PPP, including private (retail) and institutional investors.
- The People's Republic of China is about to open its public sector including healthcare slowly to private investments.

The investment needed to fund infrastructure globally is estimated at between USD 57trn (McKinsey) and 78trn (PwC) by 2025/30, with a 60% share of the Asia-Pacific region.[1] According to an investigation by the Asian Development bank ("ADB"),[2] the cost of building the infrastructure that the developing countries in Asia will need in order to maintain the economic growth that lifts people out of poverty, is estimated at 8trn USD between now and 2020. "These challenges cannot be met by the strained budgets of governments. The dynamism and resources of the private sector must play a part. . . Involvement of the private sector increases efficiency by investing in new technologies and introducing more innovative solutions. It's not only about financing. In the long run, the private sector has a larger impact on poverty alleviation than just providing money upfront."[3] The dynamic of the Asia-Pacific region is underscored by the establishment of a specialised development bank in this sector, the Asian Infrastructure Investment Bank ("AIIB").

The benefits of PPP finance materialise on both the public and the private-individual side: Macro-economically, private-sector infrastructure expenditures have been seen triggering significant accelerating effects with multipliers of 2.0 and more — i.e. 1$ spending on infrastructure can translate into 2$ of additional GDP over a three-years' period. Private-sector infrastructure investments have proved to be profitable

2. BASIC PRINCIPLES AND STRUCTURES OF PPP FINANCE

In traditional state budget funding, government authorities or other public entities are direct investors in and owners of public assets, such as real estate, utilities, hospitals, and harbours etc. Finance is provided directly to the respective public entity, either bilaterally (loans) or by tapping the capital markets issuing bonds.

[1] O'Dea, "Infrastructure: Emerging in new markets" *IP Real Estate* (May/June 2015), online: <http://realestate.ipe.com/infrastructure/infrastructure-emerging-in-new-markets/1000>.

[2] Online: <https://www.thinglink.com/scene/419753204851408897>.

[3] Jo Yamagata, *Asian Development Bank*, online: <https://www.thinglink.com/scene/419753204851408897>.

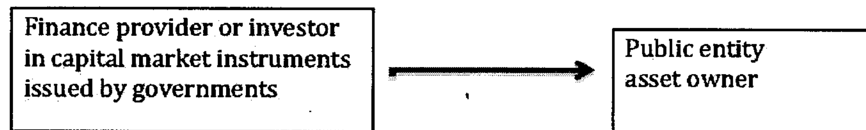

Chart 1 Traditional state budget funding

PPP finance uses different basic principles and structures, although the investments are much the same. There are two alternative structures commonly in use:

- The Lease Model;
- The Franchise Model.

In both cases, the income streams used for payment and repayment are rental income or assignment of government resources or revenues (royalties, franchise, special-purpose taxes, mandatory charges such as healthcare contributions, and/or concession revenues).

The Lease Model encompasses the acquisition, construction or ownership of public-sector assets by special purpose vehicles ("SPVs") established under private law with a lease contract between the SPV and government authorities. Sale and lease back structures are possible as well. Finance can be provided by loans or by issuance of capital market instruments (bonds), enhanced with collateral granted by the public-sector entities to improve credit-worthiness and reduce finance costs. Related enhancement regularly includes the assignment/pledge as security or the purchase or forfeit of lease or fee claims against the public-sector entity (the "authority"). Unconditional lease or fee payment by the authority would imply the same low risk as direct public-sector finance, enhanced by cash flow generated by public-sector assets. Shari'ah-compliant structures including Ijara, Murabaha and Sukuk are possible as well.

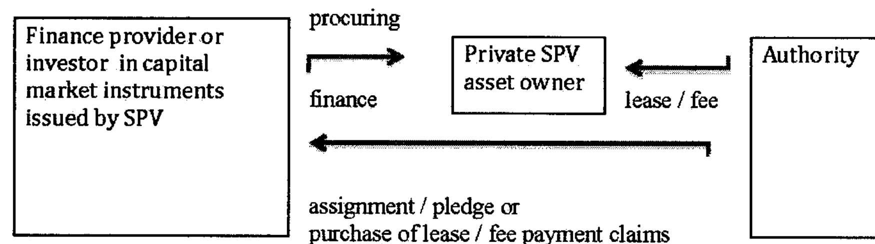

Chart 2 PPP Lease Model

Using the Franchise Model, the authority retains the ownership of the public-sector asset, but grants usufruct for the benefit of a SPV established under

private law. Key element is a franchise contract between the SPV and the authority, with the SPV operating the asset, e.g. a toll road, for public use, and collecting mandatory charges (e.g. tolls) assigned by the authority. Related income streams are used by the SPV for the payment of funding. Again, financing can involve loans or issuance of capital market instruments (e.g. bonds), and can be structured conventional or Shari'ah-compliant using Sukuk.

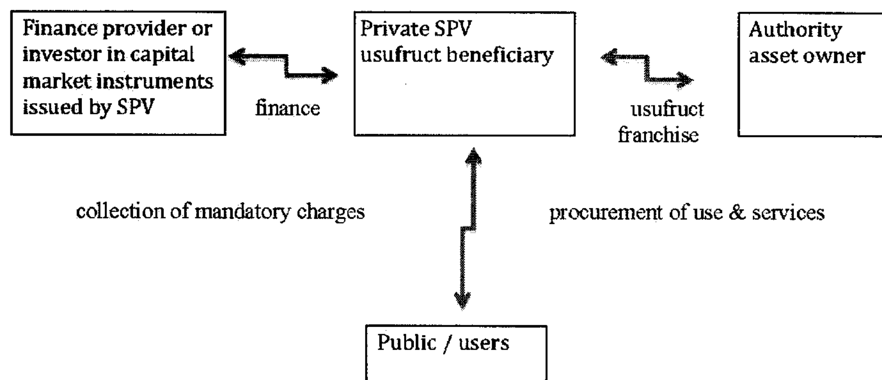

Chart 3 PPP Franchise Model

3. BASIC LEGAL AND REGULATORY REQUIREMENTS

For a successful introduction of PPP finance, specific legal and regulatory requirements regarding the validity and enforceability of related rights should be fulfilled in order to ensure safety and soundness of underlying assets and revenues, in particular:

a) Clear regulation on ownership of and charges over plants and equipment, such as

- electrical power lines, distribution and transformer stations;
- water and sewage pipes; and
- renewable energy plants such as wind and solar energy.

For this purpose, the introduction of specific public registers might be considered. Good examples can be found in Australia and in the USA.

b) Clear regulation on contracts with public entities, including assignment of and charges over related income claims, including:

- purchase commitment by public entities regarding supply of energy, water and other services;
- reliable pricing regimes and frameworks as opposed to arbitrary interventions by authorities; and
- mandatory connection of users to the public mains and mandatory usage on a fee basis.

4. IMPLEMENTATION

Shaping tailor-made individual project structures is essential in PPP finance. Funding instruments for PPP should at least to a large extent:

- match the amortisation terms of the assets or projects to be financed;
- be long-term and tailored to the investment period and income streams of the project in order to avoid temporary liquidity bottlenecks;
- accommodate premium costs and amortisation periods of environmentally responsible and resource-efficient structures and methods such as renewable energies.

Bank loans, as well as structured capital market instruments such as Covered Bonds, (or Sukuk in the case of Shari'ah-compliant finance) are suitable. In attracting private investors to invest in capital market instruments based on infrastructure projects, Covered Bonds have been successful and resilient even during the recent financial crisis. The principle is clear: real estate and public-sector projects can be used as an issuance basis of capital market instruments instead of bilateral financing. There is a world-wide trend to establish regulated Covered Bonds based on infrastructure projects and real estate (including, Australia, Canada, China, Europe, Singapore, and the USA), due to the following advantages facilitating cheaper finance:

- economics of scope and scale;
- broader investors' base; and
- added values such as providing safe investment products for pension funds and insurance companies, as well as providing liquidity for the exchanges.[4]

5. SPECIFIC RISKS AND CHALLENGES TO BE TAKEN CARE OF IN PPP FINANCE

Lessons are to be learnt from past experiences. There are a few specific types of risks and challenges involved in PPP finance:

a. Safeguarding the public interests is essential. Clear structures of decision making and powers of attorney in respect of mandating private-sector parties across the various levels of governments and public authorities are required. Regulation of tender requirements and practices would be helpful as well, supplemented by transparency and disclosure rules. All these issues should be established by explicit legislation and should be subject to control by courts of audit in order to secure the rule of law.

Other frequent cases are state aid classifications where public authorities are granting enhancement for the benefit of private-sector parties. This is of particular interest with a view to the prohibition of state aid under Art. 107 of the Treaty on the Functioning of the European Union ("TFEU").

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4 International Monetary Fund, *Global Financial Stability Report*, Chapter 3 (April 2012) at 8.

b. Securing professional handling and supervision on the part of public counterparties is a further issue. In the aftermath of the financial crisis, many court cases evolved where public authorities had entered into contracts including financial instruments with complex structures, in particular swaps and other derivatives, ending up with significant losses. The outcomes vary; many decisions are still pending. In an even earlier decision, the House of Lords held that interest rate swaps entered into by local authorities were all "ultra vires" and void.[5] On the contrary, a Dutch social housing association lacking capacity to enter into certain swap transactions was held liable under an ISDA master agreement because it had given representations about its capacity which gave rise to a contractual estoppel regarding an ISDA master agreement.[6] Another well-known case is the Austrian City of Linz with a speculative currency and interest rate swap transaction. The German Court of Appeal (BGH) distinguishes between highly complex CMS Spread Ladder Swaps and ordinary plain vanilla swaps.[7]

There is broad consensus amongst global regulators that non-professional parties must be protected against specific risks involved in complex financial instruments the handling of which requires specific knowledge and expertise. The awareness of this problem has triggered increasing regulation; related SEC rules or the EU Markets in Financial Instruments Directive[8] are good examples. As experience has shown that public authorities do not necessarily benefit from the same expertise as financial professionals and institutional investors, specific disclosure requirements and codes of conduct for business activities with public-sector counterparties are advisable. Again, the rule of law should be secured by explicit regulation and legislation.

c. Specific problems related with the enforceability or potential voidness of administrative acts and agreements between public authorities and private-sector parties are known under the term of the "ultra vires doctrines".[9] Basically, acts by legal persons that are beyond the scope of their powers are classified as *ultra vires* acts.

There is comprehensive legislation and case law dealing with these issues, regularly distinguishing between private-sector corporates and authorities acting as counterparties in agreements under private law. The outcome varies between and within the applicable national jurisdictions. The public-sector aspect

5 *Hazell v. Hammersmith and Fulham LBC* (1991), [1992] 2 A.C. 1 (U.K. H.L.).

6 *Credit Suisse International v. Stichting Vestia Groep*, [2014] EWHC 3103 (Comm) (Que. B.D.).

7 German supreme court of appeal (BGH) judgement XI ZR 316/13, 20th January 2015.

8 Directive 2014/65/EU and Regulation (EU) 600/2014.

9 See Elliott, "The Ultra Vires Doctrine in a Constitutional Setting: Still the Central Principle of Administrative Law" (1999) Cambridge Law Journal at 129; Greenfield, "Ultra Vires Lives? A Stakeholder Analysis of Corporate Illegality" (2001) Virginia Law Review November. The development of UK case law goes back to *Anisminic Ltd. v. Foreign Compensation Commission* (1968), [1969] 2 W.L.R. 163 (U.K. H.L.).

encompasses cases where a public-sector counterparty does not have the substantive power to make a decision, violates procedural requirements, acts in failure exercising administrative discretion or even abuses its power in bad faith. There is a broad area of conflict between the public interest and the protection of private-sector parties acting in good faith. Due to the significant legal and economic risks involved, powers of attorney and documentation requirements of decisions made by public-sector bodies should be legally defined as precisely as possible. Under this assumption, private-sector companies not investigating on documented evidence of power of their public-sector counterparty could be considered as acting in bad faith with the consequence of non-enforceability and voidness.

d. Regulatory risks: Private-sector parties must be protected against discretionary changes of the "rules of the game" — they expect reliable pricing regimes and frameworks as opposed to arbitrary interventions by authorities. The case of New Delhi Airport/Fraport was a negative example.

e. As far as the economic risks of PPP projects are concerned, codes of conduct should be in place on the evaluation of risks and reward including risk transfer to the private sector.

6. PPP FINANCE: EVALUATION OF BENEFITS AND DISADVANTAGES

PPP finance is not necessarily cheaper, but can be more feasible than conventional state budget finance,[10] in particular as far as transfer of risk to the private sector is involved. Depending on the situation of the individual state and the complexity of the transaction, it can be more or less expensive than global state borrowing. However, even in the case of costs being higher, the related risks transferred to the private sector have to be taken into consideration. Further, due to the structuring requirements, PPP finance can be more complex than direct state borrowing.

Nevertheless, under the assumption of appropriate handling, PPP finance has certain advantages:

The outsourcing of public functions from government budgets paves the way for tapping private-sector finance sources — domestic and international investors will be attracted by the quality and security of the underlying assets and income streams. Due to their safety and quality, related assets and revenues are suitable collateral or underlying for the issuance of capital market instruments, such as Covered Bonds. Using the Franchise Model, the authority may even retain ownership of the related public asset.

Further, PPP finance provides for added value. Due to their coverage by the public sector or by related assets and projects, capital market instruments based

10 According to a report to the German Parliament by the Court of Audit, PPP costs may exceed state budget funding by 12 to 28%, due to the extremely low interest rates paid on German government bonds.

on PPP (Covered Bonds resp. Shari'ah-compliant Sukuk) are safe assets which can fulfil important functions, as stated by the IMF Stability Reports:[11]

Such capital market instruments are eligible investments for insurance companies and pension funds (for example, in China, the National Social Security Fund). "Like real estate, we recognise that infrastructure offers attractive inflation protection and stable yields against which we can match our long-term pension liabilities".[12] This is of increasing importance in the current low-interest environment. They have sufficient critical mass to be used for liquidity management by banks. Further, they are suitable for term note programs issued periodically that can be used as indicative benchmarks, creating a benchmark yield curve for a wide range of maturities.

7. CONCLUSIONS

According to a McKinsey and Global Institute study, global debt has increased by $57 trn since the onset of the financial crisis in 2007.[13] Private Public Partnership finance can help to manage indebtedness of states and sub-sovereign entities, and can contribute significantly to stabilising the international finance markets. Six critical advantages of PPP finance include:

1. PPP finance can reduce public indebtedness and enhance access to the international capital markets. The safety and soundness of underlying assets and revenues is an alternative to the fluctuating creditworthiness of states and public entities;
2. PPP can help matching debt service and revenues of specific public assets on a long-term basis, independently from fluctuating annual budgets. Project-specific cash flow and collateral is a more reliable basis than global public budgets;
3. PPP finance can reduce excessive use of state guarantees by providing project-specific collateral of assets and revenues as an alternative;
4. PPP finance can help to improve budgetary discipline and to stabilise public budgets by decoupling specific public services and revenues from politically driven global public budgets, and hence from social and deficit spending;
5. PPP finance can reduce excessive use of state guarantees by providing project-specific collateral of assets and revenues as an alternative; and
6. PPP finance can help to calculate realistic prices for public services, because individual interest rates would tend to being risk-adequate and project-specific.

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11 *IMF*, *supra* note 4.

12 Hughes, "Legal & General", online: <http://realestate.ipe.com/news/infrastructure/lg-brings-property-and- infrastructure-under-one-roof,27.03.2015>.

13 Niall McCarthy, online: <http://www.forbes.com/sites/niallmccarthy> 10 February 2015.