KEYNOTE INTERVIEW

The rise and fall of PPPs

Patrick Mitchell and Matthew Job of Herbert Smith Freehills on what comes next for public-private partnerships in UK infrastructure

Q What were the origins of private-sector involvement in public infrastructure in the UK and how have delivery models evolved?

Patrick Mitchell: Private ownership of roads, canals, ports and railways goes back hundreds of years. And that's the way things continued, to a large degree, until a nationalisation programme after the Second World War. Then, under Margaret Thatcher – and later John Major – the airports and railways were privatised once again, along with the utilities industries. When Tony Blair came to power in 1997, he didn't do anything to upset that trend. In fact, he and Gordon Brown used private finance initiatives with great enthusiasm as tools for delivering not only schools and hospitals, but ancillary social infrastructure such as court houses, libraries and prisons.

Matthew Job: Although the modern era of private-sector involvement in infrastructure started with the privatisations of the 1980s and 1990s and then developed with the PFI/PPP boom in the late 1990s and early 2000s, it is important not to forget other initiatives, such as government support for renewable energy, as well as housing association building programmes and universities. That all formed part of this period of extensive private-sector activity.

Q What are the key advantages of private-sector involvement in public infrastructure?

PM: One key advantage is the transfer of risk from the public to private sector. It also brings an additional layer of rigour, with banks doing due diligence on everything from contractual arrangements to technical design. And while there is endless debate as to whether PFI offers better value for money all round than public procurement, what is clear is that deferral of cost has enabled many more infrastructure projects to go ahead than would otherwise have been the case.

MJ: The question of value is a perennial one. The cost of capital raised within the public sector must be lower than that raised off the government's balance sheet. But at the same time, the government is generally a poor evaluator of risk because it lacks the commercial profit motive of the private sector. The private sector has also brought a great deal of efficiency to the procurement process.

Another important advantage is whole-life costing – the idea that you are responsible, not only for building an asset, but for running it for an extended period. That means you should have greater regard for operating costs and efficiencies.

Q What have been the big success stories of recent times?

PM: We have seen more than 700 projects delivered under the PFI and PPP models. That is in addition to the private-sector investment in water, railways and, of course, the renewables industry, which has been created from scratch over the past 20 years. Given government spending constraints, without private-sector involvement, a lot of these projects would never have been built. I think the fact that so many other countries – including many in Western Europe, Central and Eastern Europe, Canada, Australia and the Middle East – have adopted these models, also speaks volumes.

MJ: The dramatic rate of cost reductions in the offshore wind and other renewable technology markets is an excellent success story. The pipeline of projects in this space has made it worth the private sector's while to build in efficiencies. Although not as well publicised, we saw a similar thing happen in the early days of PFI.

In some sectors construction design became modularised, for example: you could order different components of buildings, such as prisons, schools and hospitals, like Lego bricks. None of that would have happened without a pipeline of private sector-owned and -operated projects.

Q What about the regulated asset-based model?

MJ: RAB has been a real success story. The water industry, in particular, is widely perceived to be an exemplar of private-sector investment and custodianship.

PM: The creation of the economic regulators as creatures of statute, rather than political whim, has been hugely important in balancing the rights of investors and consumers and applying objective judgments that give investors the confidence to make long-term decisions in regulated sectors.

MJ: Of course, the regulated utility model is generally viewed as a vehicle for the operation and maintenance of existing assets, but it is actually a lot more flexible than that and has applications for greenfield development as well.

Q Delays and cost overruns are generally portrayed as failures of the model. Is that fair?

MJ: There was an example a few years ago when walls in Edinburgh schools started falling down because of poor construction. That was reported as a horror story but actually represented everything that is good about PPP.

Every one of those walls had to be rebuilt at the private sector's expense. Just contrast that with the cost overruns on a whole variety of public-sector infrastructure projects across a range of sectors, all of which were borne by the taxpayer.

Q What about refinancing windfalls that have also damaged public perceptions of PPP?

MJ: There are two elements to the refinancing gains we have seen. One is the upside that comes from a project that is gradually de-risked as it is delivered. I think that is entirely fair. But the reason I think these gains became such a sensitive matter is that we have also seen a dramatic improvement in the efficiency of the infrastructure capital structure.

Infrastructure returns have fallen dramatically and that has enabled existing owners to benefit significantly from increased asset values deriving from market conditions rather than project improvements. This has fuelled negative sentiment. When you read the stories about the gains made by certain investors in the water sector, for example, many would view that as a windfall for the private sector.

How Thames Tideway broke the RAB mould

The regulated asset-based model first emerged in the UK and is associated with the privatisation and subsequent sustained investment in the country's utilities.

Its objective is to help balance the interests of consumers and investors. Today, it is used widely across network businesses, water and sewerage, and airports in the UK and has been extensively adopted around the world.

The RAB model is attractive because it delivers a low cost of capital compared with other private-sector procurement models. It is also far more flexible than a traditional PPP. It provides for long-term private-sector ownership while also allowing for reassessment and revision throughout the asset life cycle.

The model was historically only used in relation to existing assets. However, the Thames Tideway tunnel – London's 'Super Sewer' – was a greenfield project that broke the mould. The question now is to what extent RAB can be applied to other greenfield developments in sectors ranging from airport runways to power generation and flood defences. Herbert Smith Freehills is currently advising EDF on how the model might be used to finance nuclear power on the new Sizewell C project.

Q What other challenges have there been?

MJ: Because of the early successes of the PFI model, it began to be used as a procurement tool for projects that weren't a good fit – projects that had low capital value but complex operating models. I am thinking particularly of applications in the defence sector and a variety of road, building or system management and upgrade projects, for example. Some of those got into difficulty because of highly complex service specifications. The economic buffers of the amortisation of large capital assets against relatively low operating expenditure had also been reversed, and so the economics of the model were no longer as robust.

PM: I would add that the long-term nature of these projects means the terms that you set out with may not be fit-for-purpose at the end. And the change mechanisms built into contracts can be complex and cumbersome, particularly in projects with complex operating-phase requirements.

The behaviour the model has encouraged has also been an issue. The third P in PPP stands for partnership. But the rigid nature of the contracts, coupled with aspects like KPI payments or deductions, sometimes encourages a more adversarial relationship, with public counterparties running contractual provisions to make deductions. There have also been instances where the private sector was perceived to be charging disproportionately for contract or service variations.

MJ: There is anecdotal evidence that in periods of contracting government expenditure, authorities have been going back through contracts to search out ways of reducing payments to the private sector. In extreme cases, consultants are even ambulance chasing – offering to go through contracts to find ways to cut costs.

Q In many ways, it was the collapse of Carillion that brought us to the current PPP hiatus. What are your views on what happened?

PM: My view is that Carillion was not brought down by the PFI model but by a combination of how the business was managed and the fact it found itself having to redo elements of work.

MJ: In many ways it is a demonstration of the efficiency of the pricing model. You only know when someone has gone too low when they fail. And it was the shareholders that took the primary hit with Carillion.

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> **PATRICK MITCHELL**

Q The government has called a halt on PFI contracts and a Treasury infrastructure finance review is underway. What next?

MJ: There is still a vibrant infrastructure market in the UK. There is a successful renewable energy market and while we may see fewer big infrastructure projects than in the glory days, we still have projects such as Thames Tideway, Hinkley Point C and HS2 being developed. Hopefully, we will see the Sizewell C new nuclear project brought forward with a RAB revenue model. We also know that the government wants to increase infrastructure expenditure and that there is a known pipeline of work around things like flood defences.

It is clear that private-sector involvement in delivering this infrastructure is not going to go away. It just can't. Even if you look at the most extreme form of public ownership you still need to have private-sector involvement in its construction and operation. The government simply doesn't have the manpower to bring everything in-house.

Q We also face unprecedented polarisation in UK politics. Where will that leave private-sector involvement in infrastructure?

MJ: We have to ask whether the dominant political philosophy will be left- or right-wing and then how extreme that left or right leaning will be. Because on the basis of stated policy, you can see a left that is strongly in favour of public ownership and a right that not only believes the public sector should not own infrastructure but that the taxpayer shouldn't pay for it either – that the correct person to bear the cost is the consumer.

Q So what is the best mechanism for future private-sector involvement in infrastructure and what lessons can the UK take from around the world?

PM: There are a number of lessons the UK could take. Canada, for example, has a more dialogue-based approach to PPP, which encourages co-operative behaviour. Australia has a less centralised approach to holding the purse strings, with individual states being allowed to invest a proportion of the sale proceeds of infrastructure assets in developing new greenfield infrastructure.

MJ: What we see around the world is countries competing to offer up good pipelines of sensibly thought-through projects, in order to incentivise investors to apply time and capital within their borders. I think we should reflect on the fact that the UK has no divine right to foreign investment. The UK also needs to learn from jurisdictions that have procurement models that can deliver those projects quickly and efficiently, with less development cost at risk prior to signature. The concession agreement for PPP projects in the Netherlands can be under 100 pages. The concession agreement for even relatively straightforward PPPs in the UK can be over 1,000 pages. The Netherlands model might not extract every last ounce of risk transfer, but it's quick, it's efficient and it works. ■

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