

NOT SO BRIGHT? the DARKER SIDE of PPPs



Public-private partnerships (PPPs) are being debated in New Zealand for new roads and other major infrastructure. They've long been popular in Australia and the United Kingdom, where they harness private-sector innovation and efficiency to deliver infrastructure at lower cost and lower risk to taxpayers. But, as David Ehrhardt reports,¹ it's becoming clearer that PPPs have their dark side.

Many private infrastructure projects involve:

- regulation or contracts that subject the private company to considerable risk
- high leverage (debt:equity ratio) in a project-finance structure
- a government or regulator reluctant to let the provider fail.

Together, these factors can mean that shareholders and bankers get the profits during good times – but in bad times customers and taxpayers pick up the tab. Three examples in Australia, the United Kingdom and Brazil cast light on this darker side of PPPs.

Melbourne transport

In 1999 the state government of Victoria contracted out Melbourne's tram and train services. Top international transport operators competed, with the franchises going to the companies willing to provide good services for the lowest subsidy. On awarding the contracts, the state government announced that it had achieved total savings of A\$1.8 billion over the life of the franchises (compared with the cost of public-sector operation).

Under the contract, the operators took on the operating-cost and demand risks. The demand risk was amplified by the fact that roughly a third of the anticipated subsidies

were linked to the level of passenger growth – and, within a few years, the franchisees began to hit financial difficulties. They could not achieve the patronage growth and cost savings forecast.

The total capital put at risk by the operators was around A\$135 million in equity and performance bonds – only 7.5% of the anticipated savings to the government. By 2001, the operators had concluded that anticipated losses over the lifetime of the contract exceeded the value of the equity and performance bonds at risk. They presented the government with an ultimatum: increase the subsidy and reduce the operators' risk – or the operators would terminate their contracts.

The state government concluded that it was best to negotiate, as it did not want to take the services back into the public sector. An analysis of the market showed it was unlikely to get a strong field of bidders if it re-tendered the contract. In the course of the complex renegotiations, one of the operators (National Express) was not able to reach agreement with the government – and it left, losing its performance bond. The other two (Connex and Transdev) each took over part of National Express's business, and retained their existing franchises, in exchange for substantial increases in subsidy and reductions in risk. The government's expected savings and risk

transfer ended up being less than expected.

UK air-traffic control

National Air Traffic Services (NATS) is the air-traffic controller for the United Kingdom. In March 2001, NATS was partially privatised. A consortium of seven British airlines took a 46% stake in the company, a 5% stake was held for employees, and the government retained a 49% stake.

NATS' charges were subject to a price cap, to be reviewed once every five years. Between these five-yearly reviews, NATS took all the demand risk.

NATS had been forecasting strong growth in demand; but, after the terrorist attacks of 11 September 2001, air-traffic volumes plummeted. The company was highly indebted, with leverage of at least 92%. As demand fell, NATS was not able to service its debts – and bankruptcy loomed. NATS asked its regulator, the Civil Aviation Authority (CAA), for help.

CAA Board member Doug Andrew balked. He argued that NATS' bankers should write down its debt to a level it could service. The rest of the CAA Board disagreed, as did the British government. The government injected equity of £100 million into NATS. The CAA raised NATS' price cap, and also reduced the amount of demand risk the company bears. Together, customers and taxpayers

shouldered the risk they had apparently transferred.

Sao Paulo's electricity

Eletropaulo Metropolitana is the electricity provider for Sao Paulo, Brazil's largest city. Eletropaulo was privatised in 1998 for \$1.78 billion. Through a complex structure, the US energy company AES came to own around 70% of Eletropaulo. This meant that although Eletropaulo itself did not appear to be highly leveraged, it was. An asset valued at US\$3.6 billion needed to generate enough cash to service a debt of US\$2.8 billion, creating effective leverage of close to 80%. Most of the loans were from the state-owned Brazilian Development Bank (BNDES).

Brazil's electricity system relies on hydro-generation. In 2001 low rainfall, compounded by an underinvestment in generation capacity, created shortages. The government introduced rationing – and so power sales fell, as did Eletropaulo's profits. At the same time the Brazilian real depreciated rapidly, increasing the local currency cost of serving the US\$-denominated debt. By May 2003 the AES financing companies had defaulted on loan payments totalling over US\$600 million.

BNDES had the right to claim the shares in Eletropaulo when AES defaulted, but it was reluctant to do so. It did not want to renationalise the asset and perhaps undermine the wider investment climate in Brazil. Instead, BNDES agreed to a debt-for-equity swap which left AES with a majority stake.

Once again, risks that the government thought it had transferred came back to haunt taxpayers when the going got tough.

A dangerous cocktail

New Zealand too has had some experience with government bailouts of indebted infrastructure/service providers (Tranzrail and Air New Zealand spring to mind). High leverage, regulatory or market risk, and governments who do not want these providers to fail are clearly a dangerous cocktail that can leave customers and taxpayers with a nasty hangover.

This is because private infrastructure providers are usually special-purpose companies. The amount of downside risk they can absorb is effectively limited to the amount of equity they have. When things go wrong – when costs increase, or revenues fall – the first effect is to reduce shareholders' returns. But a shock which reduces operating cashflow to such an extent that the provider can no longer

service its debt cannot be absorbed: it will lead to a default, forcing the company into bankruptcy (unless the lenders agree to restructure the debt). Since governments do not want essential-service providers to go bankrupt, they often step in to provide subsidies or relax regulatory rules. Knowing this, companies may choose high leverage levels, limiting the amount of risk they have to absorb before getting a bailout.

Anticipating the 'morning after'

Overcoming these problems is difficult – but there are options:

- reducing the amount of risk which contracts and regulation attempt to transfer
- requiring private infrastructure providers to limit their leverage
- making it easier for governments to let private infrastructure go bankrupt.

"a dangerous cocktail that can leave customers and taxpayers with a nasty hangover."

Reduce the transfer of risk

In some cases, the best approach may be to reduce the risk of bankruptcy by building explicit risk-sharing mechanisms into transaction designs. For example, PPP contracts could provide for tariffs to adjust in response to changes in demand and input prices, or provide for resets or profit-sharing if returns move outside a pre-defined band.

Require a limit on leverage

A disadvantage of reducing the riskiness of contracts is that a company might respond to the lower risk-transfer by increasing its leverage, leaving the likelihood of bankruptcy unchanged. Options for preventing this include a requirement for guarantees from the parent company, minimum equity levels in the project company, third-party guarantees or performance bonds – all of which aim to ensure that the capital at risk reaches stipulated levels. At a minimum, governments should avoid guaranteeing project debt, because this distorts financing choices in favour of debt.

It could be argued that stipulating minimum levels of sponsor capital at risk will increase the cost of project finance. However, this might sometimes be a price worth paying to transfer risk effectively from consumers and taxpayers.

Let private providers go bankrupt

Governments do not like private infrastructure providers going bankrupt because they fear the disruption of essential services. An obvious solution to this is to give the government the power to intervene in the event of financial distress, to ensure that service provision continues.

Governments often do have this power, but choose not to use it. For example, the UK government had the power to take control of NATS; but they chose to ease its price cap instead. The same is true of the Victoria state government and Melbourne's urban-transport franchises. And when Railtrack in the UK was faced with bankruptcy, the government used its powers to put the company into 'railway administration' – but it also indemnified both debt providers and shareholders against losses, to avoid law suits and to ensure continued financing.

Another option is to encourage the company's lenders to use 'step-in rights' to take over management in the event that a company appears likely to default. The government could require that the contractual documents give the lender an obligation to continue providing services, if it exercises its step-in rights. So the lender would act as the government's agent, taking action to ensure the provision of services at the same time as securing payment of its debt.

In Australia and elsewhere PPPs are used to provide much-needed roads, improved public transport, and even new schools and hospitals. They have promise for New Zealand, too. But, when they consider the costs and benefits of private financing, governments also need to think about whether the hoped-for savings are robust – or whether they'll wither away, if things turn bad.

¹ This article is based on: David Ehrhardt and Timothy Irwin. 2004. *Avoiding Customer and Taxpayer Bailouts in Private Infrastructure Projects: Policy toward Leverage, Risk Allocation, and Bankruptcy* World Bank Working Paper No. 3274 April.

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