

# *Public-Private Partnership Health Check: Managing partnerships during their lifetime*

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## *Executive Summary*

Despite the effects of the financial crisis, private-public partnerships (PPPs) continue to be widely used as a means of realizing public infrastructure projects with the assistance of private finance. The recent reforms to the Private Finance Initiative in the United Kingdom have cast light on some of the problems faced by earlier generations of PPPs—not least in terms of economic, environmental and social sustainability. This briefing examines the scope of the reforms before turning to a wider consideration of what is meant by sustainability in the PPP context. Means of assessing value-for-money, environmental impact, social returns and other key indicators—both at the outset and during the lifetime of PPPs—are discussed. Recommendations are presented for how these indicators can be addressed within the legal and commercial constraints of existing agreements.

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## *Introduction*

In 2012 the IISD published a report looking at the international use of public-private partnerships (PPPs) and their implications for sustainable development (Colverson & Perera, 2012). One of the findings of this report was that:

It is difficult for governments to amend [PPP] contracts to reflect evolving sustainable development priorities and environmental and social laws, as well as changing market dynamics ... [A]ny renegotiation that is necessary under the PPP is often removed from the competitive nature of the original tender negotiations and limits the decision-making abilities of the public sector, while the balance of power is also likely to have shifted to the private sector. (Colverson & Perera, 2012, p. 49).



The long-term nature of most PPPs, typically 25 years or more, exacerbates the problem. This paper looks at the scope that public authorities have to check the performance of existing PPPs against sustainability criteria. These criteria encompass the economic, environmental and social aspects of sustainability. Where performance falls short or circumstances have changed since the time of the contract award, it may be possible to agree on changes with the private partner(s) that will improve performance. This must be done with regard to the commercial aspects of the contract and the relevant public procurement rules.

While this briefing note draws primarily on the United Kingdom context and looks at the proposed reforms of the Private Finance Initiative, many of the ideas and recommendations are relevant for other jurisdictions. A companion IISD briefing, *Financing Sustainable Public-Private Partnerships*, examines the financial mechanisms underlying most PPPs and how these affect the sustainability of infrastructure projects.

## Context

Many public authorities have entered into long-term PPPs to deliver projects in cooperation with the private sector. In the United Kingdom, the Private Finance Initiative (PFI) has been used to establish over 700 projects since its inception in 1992. These range from the design, construction and operation of schools and hospitals to the provision of waste management services, street lighting or transport infrastructure. In 2010–2011, the total present value of existing PFI obligations in the United Kingdom was £144.6 billion, including service charges (HM Treasury, 2012). This compares with public sector gross investment of £59.9 billion in 2010–2011 (HM Treasury, 2011, p. 19).

PFI projects have come under scrutiny in the United Kingdom due to concerns about value-for-money (VfM), transparency and sustainability, with projects overrunning on costs or failing to deliver to the expected standards. On the other hand, some PFI projects are seen to operate well and offer good VfM to the public sector. In 2011 the United Kingdom Treasury announced that it would be seeking £1.5 billion in savings across operational PFI projects in England, representing just over 1 per cent of the present value of PFI obligations. In December 2012 the Treasury announced a new form of financing, called Private Finance 2 (PF2), which aims to address some of the criticisms of the old model.

The main reforms introduced are:

- The government will take a minority equity stake in many projects, to be managed by a separate unit within the Treasury.
- The maximum time period for PFI procurement will be 18 months.
- Soft facilities management services, such as cleaning, security or catering, will be removed and tendered separately.
- Secondary funding competitions will be introduced after the preferred bidder stage, aimed at attracting institutional investors such as pension funds.
- Private investors will be required to publish forecasted and actual equity returns. Gain share provisions will apply to unused life-cycle reserve funds.
- Public authorities will be able to alter the hand-back conditions for assets.

A standardized services output specification and a payment mechanism have also been developed for accommodation projects. It is too early to pass judgment on how these reforms are likely to affect VfM and sustainability in the next generation of PFI projects in the United Kingdom;<sup>1</sup> however, the change in approach helps to identify some of the weaknesses in earlier arrangements. As many of these earlier projects are still running, it is an opportune time to consider the extent to which existing PFI projects may be modified during their lifetime, with a view to securing more sustainable outcomes.

A 2011 report of the Public Accounts Committee identified a number of problems with the decision-making process for PFI projects. Among its recommendations was that the costs and benefits of projects should be revisited after contracts are signed, and periodically thereafter. But can public authorities act on such reviews and seek to amend existing arrangements? Given the long-term nature of most PPPs, waiting until the end of the contract is often not a satisfactory solution. Many PFI contracts have built-in review intervals, often linked to the schedule for debt refinancing or other milestones. This briefing note seeks to identify ways in which sustainability considerations can be incorporated in such reviews, and the legal possibilities for making changes.

In 2008 the National Audit Office published guidance on making changes in operational PFI projects. This identified a number of challenges associated with making such changes, in particular:

- Many contracts left the scope for changes and the associated charges unclear.
- Prices for minor changes under PFI contracts, such as additional electrical sockets, were often significantly above comparable market prices.
- Competitive tendering was often not carried out by the private partner, even for larger changes (in the sample, 29 per cent of changes were competitively tendered).

There is a need to apply caution when re-opening any existing PPP agreement, as in some cases a delicate balance will have been achieved between the interests of the parties. However, in some cases there are clear benefits to seeking changes that will outweigh the costs, especially where the underlying assumptions that informed the initial deal have shifted. One indication that such modifications are possible is the £1.5 billion in savings announced by the Treasury as part of its Operational PFI Savings Programme.

The next section looks at the type of sustainability considerations that may inform the review of existing PPPs, and help to determine whether changes should be sought. Examples are given of ways in which public authorities can address sustainability concerns arising during the lifetime of PPPs, and assess the legal and commercial implications of any changes. The role of specific contractual terms in facilitating such adjustments is examined. The briefing note concludes with some recommendations for how to structure and re-structure PPPs to enhance sustainability.

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<sup>1</sup> The first set of projects to be procured using PF2 is the Priority Schools Building Programme. This is being centrally procured by the Education Funding Agency on behalf of the Department for Education, with procurement of the first group of schools beginning in spring 2013.

## Existing PPPs: Checking for Vital Signs

Key sustainability considerations that may be taken into account in the review of existing PPP contracts are identified below.

### *Economic Sustainability*

Economic sustainability in the context of PPPs implies the following:

- The overall project cost represents VfM for the public sector.
- Private partners are able to stay in business and pay employees, subcontractors and creditors.
- Investors are able to earn a return on their investment.
- The broader economic impacts of the project—such as on employment, other public spending and services, property prices, competition or productivity—are taken into account, and negative impacts are mitigated where possible.

Each of these points merits closer consideration.

### **Public Sector VfM**

PPPs are normally assessed on the basis of VfM, but the scope of this analysis varies greatly between projects. The costs analyzed may be limited to those incurred directly by the awarding authority (e.g., the unitary payment and procurement costs for a PFI project), or they may include other committed public sector funds, such as PFI credits or guarantees. In some cases, costs to the end-user, such as tolls on a highway or waste collection charges, will also be included in the VfM analysis. Failure to adequately assess the full cost of a project prior to financial close threatens not only public sector value, but also the long-term viability of the project and, potentially, other public services. The need to secure better value is a major motivation for seeking to renegotiate existing contracts, especially where the scope of requirements or other underlying assumptions have shifted.

While the private partner is generally expected to take on the financial risks associated with the project, this risk transfer inevitably comes at a cost.<sup>2</sup> A more detailed analysis of VfM allows the public partner to choose the best option and ensures that it does not pay too much for the transfer of risk. It can also benefit the private partner by providing greater transparency around expectations for the project—as these will be considered more carefully where there is a clear cost attached to them. The broader the scope of the VfM exercise, the more chance there is that it will allow a realistic appraisal of the cost of the project over time. For certain cost categories, such as future utility payments and interest rates, assumptions must be made. Examples of potential approaches to VfM for different project cost elements and risks are shown below.

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<sup>2</sup> For more on the risk-return relationship, see Turley and Semple (2012).

**TABLE 1: EXAMPLES OF VFM APPROACHES FOR DIFFERENT PROJECT COSTS/RISKS**

PROJECT COST ELEMENT	RISK	APPROACH TO VFM
Utility costs during period of operation	Future volatility in the cost of gas, electricity and water	Invest to save: energy- and water-saving design features installed
Maintenance costs during period of operation	Unknown maintenance costs, change in use or new legal requirements (e.g., health and safety)	A schedule of costs may be agreed for maintenance tasks at the outset, with each partner taking some risk on changes
Capital cost of installing renewable energy generation on site such as solar panels or wind turbines	Reduction in energy bills will depend on actual output of installations, the price of electricity and grid infrastructure	Gain share: private operator benefits from energy savings up to 10 per cent above projected levels, public sector client benefits from savings above this

One approach that can limit exposure to future price volatility while also offering environmental benefits is “invest to save.” This involves a trade-off between capital and operational expenditure by investing in energy efficiency or renewable energy generation measures, and is particularly applicable to PPPs for the construction or renovation of buildings. It may also involve other design measures such as the use of low-maintenance finishes or water-saving features, both for buildings and other assets such as civil engineering works.

While such design features can clearly enhance both VfM and sustainability, it may be difficult to determine at the outset what the true added value is. For example, if solar panels are offered for installation on a school, how can the upfront cost of these be compared to the potential savings on energy costs over the lifetime of the building? One approach is to include gain share provisions in the agreement, whereby the contractor will benefit from energy savings up to a certain threshold (say 10 per cent of the predicted total energy consumption) and the public sector client will benefit from any savings in excess of that amount. In theory, this gives both partners an incentive to invest in energy-saving technology, without inflating upfront costs unduly.

A key question in assessing VfM is what it should be benchmarked against. Unlike conventional procurement, most PPPs have reached the preferred bidder stage before a comprehensive assessment of all cost categories is possible. This is due in part to the need to involve investors and the difficulty in maintaining competition over the lengthy period often needed to finalize contractual terms. If rival bids can no longer be compared at this stage, the public sector client must find a way of comparing the final offer to other options or benchmarking it against similar projects.<sup>3</sup> This has been a weakness in the existing PFI procurement model in the United Kingdom, and concerns have arisen about the real costs and benefits of many projects currently underway. Given the widespread use of PFI and the relative lack of other forms of infrastructure investment, comparison with other forms of financing has, at best, been difficult and, at worst, illusory.

**Private Partner Viability**

The financial and technical capacity of the private partner to deliver the project is normally assessed at the selection stage, with additional checks (due diligence) carried out just before financial close. However, shifting financial circumstances can affect any contract, and the long-term nature of most PPPs means that this risk is greater. If a private partner is struggling financially, the existence of contractual remedies such as termination or penalties may be of little

<sup>3</sup> This is often done via a “Public Sector Comparator”: the notional cost of attaining the same results by public sector procurement.

comfort. The existence of a step-in clause may help to ensure that the project reaches completion, but the process for applying this is not always straightforward, and in some cases the public partner lacks effective capacity to avail of the clause. Assessing the economic sustainability and stability of a PPP may require a more sophisticated approach to financial checks and guarantees, both at the outset and during delivery.

If the private partner's finances deteriorate significantly during the lifetime of the PPP, the public partner will want to know about the situation as soon as possible and have full disclosure of relevant accounts. These provisions will normally be contained in the project agreement and articles of association of the project company. One of the measures introduced under PF2 is a requirement for greater transparency regarding the equity internal rate of return for the project and each of the shareholders. However, this information will not necessarily reveal weaknesses in the private partner's finances outside of the project company, or of major subcontractors. Establishing a clear view of potential risks and procedures to be implemented where a private partner is in financial difficulty should be a priority both at the outset of a PPP and during any midterm review.

### **Investor Returns**

PFI and other PPP arrangements are sometimes criticized for generating windfall gains for the private sector. While in some cases this criticism may be well placed, investors cannot be expected to back projects if there is no return for making their capital available. The question of what constitutes a "reasonable" return has not always been addressed in a transparent manner in public sector policy guidance on PPPs. One study found that for the first 12 acute hospitals financed via PFI, shareholders earned post-tax returns in excess of 58 per cent in 2005 (Shaoul, Stafford & Stapleton, 2008, p. 106). Although lower or negative returns were recorded in earlier years, such figures still contrast sharply with what might be considered a more normal rate of post-tax return of 8-15 per cent.

The Scottish Non-Profit Distributing model of PPP aims to address the problem of excessive investor profits by capping private sector returns and eliminating dividend-bearing equity. It is not a "not for profit" model—contractors and lenders are expected to earn a rate of return determined by competition. The Scottish Futures Trust, which has developed the model and is currently applying it to a pipeline of revenue-financed public infrastructure projects worth £2.5 billion, explains the approach to the rate of return as follows:

The investor rate of return, bid in competition, should reflect the level of risk transfer negotiated. It is important that the risk transfer is sustainable and so the risks passed to the Project Company should be evaluated against the cash flows in the NPD model to ensure that, in the absence of equity, these risks can be managed effectively. The sustainability of the proposed risk transfer should be evaluated in a sector-specific context and procuring authorities should seek advice in carrying out such an assessment. (Scottish Futures Trust, 2011, p. 7)

One consideration that must be taken into account is the potential trade-off between limiting investor returns and ensuring competition during the award phase of a PPP. Comprehensive data on the number and quality of bidders for PPP projects are seldom available, making analysis of the link between different financial models and levels of competition more difficult. It will be interesting to observe the behaviour of the Central Government Unit charged with managing the United Kingdom government's equity stakes under PF2, to see what average levels of return it achieves.



## Broader Economic Impacts

As with any infrastructural project, PPPs typically have knock-on effects on the local and regional economy. For example, the construction of a waste management facility will affect local property values, traffic flows and the development of adjacent areas. Employment may be created, or existing jobs may be transferred from the public to the private sector.<sup>4</sup> With projects running for 20 years or more, knock-on effects become more difficult to predict. These considerations are normally addressed at the planning or impact assessment stages; however, they may need to be revisited as economic cycles, demographics and other factors change over the period of most PPPs. A further consideration under this heading is the effect that currency valuations, interest rates, inflation and taxation will have upon PPP finance.

In the United Kingdom, one area of controversy has been the tax liabilities of project companies and equity investors, many of whom are based overseas. While such structures may be legal and within the mainstream of corporate practices, there are particular sensitivities regarding the perception of tax avoidance where public sector funds are involved. As with scrutiny of rates of return, in some cases, there may be a trade-off between actions to discourage tax avoidance by private sector partners and the ability to attract investment. This is an area where further development of good public sector practice is needed, to identify strategies for limiting tax avoidance without jeopardizing the availability of private finance.

## Environmental Sustainability

Environmental sustainability in the context of PPPs implies that:

- The environmental impact of the project throughout its life cycle has been considered.
- To the extent possible, negative environmental impacts have been avoided, reduced or offset.
- All partners and subcontractors in the project, and the eventual users, are incentivized and enabled to address the environmental impact of their activities.
- Adaptation to climate change has been considered in the design of projects.

## Environmental Impact Assessment

The environmental impacts of a PPP project will typically include raw material usage; land-use change; effects on biodiversity; traffic and transport; greenhouse gas emissions; air, water and ground pollution; energy use and generation; and water use. The full list of impacts will vary depending on the project and the locality. The importance attached to these various impacts will also depend upon local or regional environmental priorities. There are certain guiding principles regarding how environmental impacts should be considered. Life-cycle assessment (LCA) is the “gold standard” for this, considering impacts throughout the entire life cycle of an asset, from raw material extraction through use and end-of-life processes. Several ISO standards exist to regulate the conduct of LCA, such as ISO 14040:2006 and ISO 14044:2006.

LCA should be distinguished from life-cycle or whole-life costing (LCC/WLC), in that it does not assign costs and covers impacts, which may not be borne directly by the client or operator (e.g., upstream or embedded emissions.) LCA may be used to compare the impacts of two different materials or building designs, for example, or to compare

<sup>4</sup> The Transfer of Undertakings (Protection of Employment) Regulations 2006 apply where an existing undertaking changes ownership, and serve to protect hours of work, pay and other entitlements excluding pensions.

the contribution of different life-cycle phases to the total greenhouse gas emissions associated with a project. Because it covers a range of environmental impacts, it is a more sophisticated measure than a carbon footprint. The cost of conducting a full LCA can also be higher than other indicators of environmental impact, and so it may not be appropriate for every application. However, LCA is broadly used in the construction industry, so potential partners can be asked about their use of this or other indicators at the tender stage, to determine the best way of measuring a project's true environmental impact.<sup>5</sup>

**Mitigating Impacts**

A common approach to mitigating the environmental impact of building projects is to set targets in terms of the energy performance of the completed asset, or carbon dioxide emissions per square metre. Requirements for the use of recycled materials, or handling of resources and waste during construction, are also often included. Energy and water consumption, or other aspects of in-use environmental performance, can be difficult to predict accurately. These depend upon the usage patterns and behaviour of users as well as the actual performance of materials and systems. Other environmental considerations, such as rates of recycling, can also be affected by factors controlled by either party. For these reasons, targets set during the design phase to mitigate the environmental impact of PFI projects may be found to be either over- or under-ambitious once the asset is in operation. Efficiency standards should be monitored following hand-over to determine the true performance across seasons and at full occupancy. Ways in which performance gaps can be addressed, and continuous improvement supported, can then be agreed with the private partner and any investors underwriting environmental performance.

**Ownership of Environmental Issues**

Establishing ownership of environmental issues can be a major challenge in PFI and other PPP arrangements. The private partner is typically involved in the operation phase, and so the users or public sector client may feel that responsibility rests with them. However, as with risk, ownership of environmental issues in a PPP is best assigned to the party that is in the best position to manage it. This is likely to result in a breakdown of specific environmental responsibilities between the various parties involved, including the users. For example, the breakdown in Table 1 might apply in a PFI to build and operate a hospital building.

**TABLE 2: OWNERSHIP AND TARGETS FOR ENVIRONMENTAL ISSUES, HOSPITAL PPP**

ENVIRONMENTAL ISSUE	OWNER	TARGET
Recovery of materials during demolition and construction	Construction contractor	Recover a minimum of 70 per cent of construction materials for recycling or reuse.
Maintenance of boiler to maximum efficiency levels	Facilities manager	Boiler to operate at 90 per cent efficiency over 12 months.
Purchase of energy-efficient IT equipment	Public sector client/trust	All equipment to meet Energy Star standards or equivalent.
Recycling of waste during use phase	Users	55 per cent of all non-hazardous waste to be recycled.

<sup>5</sup> Guidance on LCA in the context of energy-efficient buildings is available at <http://www.eebguide.eu>



Along with targets, owners of environmental issues should be incentivized to achieve continuous improvements in performance wherever possible, for example by benefitting from the revenue linked to energy savings or reduced landfill charges.

### **Climate Change Adaptation and Mitigation**

Many public authorities are beginning to plan for adaptation to climate change, for example by designing infrastructure projects that respond to the anticipated changes in hydrological cycles. There is an untapped potential for PPPs to facilitate climate change adaptation and mitigation. For example, there is scope for enhanced investment in the refurbishment of old and inefficient infrastructure, resource-efficient roads, schools and hospitals, or advanced ecological and adaptive infrastructure. Incorporating the conversion of waste into energy in the design of PPPs is another example. While many of these design features would need to be considered from the outset of a PPP, in some cases a retrofit or even routine maintenance can address considerations linked to climate change.

Investors may be pleasantly surprised at the funding options for taking the initiative on climate change. Green revenue sources such as carbon funds are available to project owners/operators that demonstrate commitment to lowering greenhouse gas emissions in their activities. There is also scope to capitalize on special loans and mortgages for investments in buildings and projects with green features, especially those related to energy savings. In the United Kingdom, for example, the Green Investment Bank was set up in 2012 as a publicly owned bank making commercial investments in offshore wind, waste and non-domestic energy efficiency. In the United States, President Obama's Better Buildings Initiative provides competitive grants and loans for energy efficiency upgrades (White House, 2011). The European Union and European Investment Bank also finance many investments related to climate change mitigation and adaptation.

### **Social Sustainability**

Social sustainability in the context of PPPs may address the following factors:

- Ethical working conditions and payment of a living wage to workers involved in the raw material production, design, construction and operation phases.
- Consideration of the project's impact on the local community and broader society, and mitigating any negative impacts where feasible.
- Planning to maximize the social returns to a project, for example by involving disadvantaged groups or social enterprises.

### **Ethical Working Conditions and Wages**

PPPs employ a large number of people, both directly and indirectly. Supply chains typically stretch across the globe, with only the most visible impacts occurring locally. Differences between public and private sector job conditions are often thrown into the spotlight when roles formerly carried out in-house, such as facilities management, cleaning, catering or security, are transferred to a contractor. The Transfer of Undertakings (Protection of Employment) legislation protects some of the rights of workers; however these rules do not apply where entirely new services are being provided. The private partner will typically see working conditions as falling within its discretion, once the legal requirements in the

jurisdictions in which it operates have been met. However, this does not necessarily have to mean “lowest common denominator” conditions and wages. A growing awareness of corporate social responsibility means that many private sector companies are conscious of both the perception and the reality of poor working conditions in their supply chains, and are taking steps to address these.

Conditions such as paying a living wage to all workers, protecting pension rights and recognizing unions may all form part of the negotiation process for a PPP. Sourcing of raw materials and supplies from companies that observe the core International Labour Organisation standards is another example of a commitment that can both contribute to the social sustainability of a PPP and boost the corporate image of the private partner. Initiative on these matters may come from either party, but if the public partner is serious about such commitments, it should ensure they are reflected in the contract terms, that mechanisms are in place to monitor compliance, and appropriate remedies exist for any breaches. As these conditions are likely to affect the bottom line and rate of return realized by investors, they should be introduced at an early stage in the procurement process so that all parties are clear on them.

### **Impact on Local Communities**

Public authorities are normally obliged to consult with the local community before undertaking an infrastructure project. This most often takes place at the planning stage, through a formal consultation process, open meetings and/or voting by a local council or assembly. Some of these processes are more effective than others at identifying the full range of social impacts and how they can best be addressed in the project. If there is widespread objection to the project, it is more difficult to have a constructive process. On the other hand, if the project has broad acceptance in the community, there may be a temptation to simply “tick boxes” without considering the long-term effects. For example, building a new school is likely to be positively received, but if local enrolment is insufficient then there will be economic, environmental and social costs incurred to bus students from other localities.<sup>6</sup>

### **Maximizing Social Returns**

In the United Kingdom, the Public Services (Social Value) Act 2012 requires public authorities to have regard to economic, social and environmental well-being in connection with public services contracts. This might be achieved by involving social enterprises in the delivery of services linked to a PPP or by ensuring that a minimum number of apprenticeships or jobs for disadvantaged workers are created. The overall design of a PPP project will also affect social returns—for example, a building can be designed, located and managed in a way that encourages use by multiple groups, including disabled users, those on low incomes or other marginalized members of society. As with environmental issues, creating a sense of ownership and incentives to improve social performance is key if this is to be part of the “triple bottom line”<sup>7</sup> in a PPP project.

<sup>6</sup> In one case, a PFI- financed school in Northern Ireland, Balmoral High School, was closed after just five years due to insufficient enrolment and the excessive cost of bussing students from other neighbourhoods.

<sup>7</sup> A “triple bottom line” means that the financial, environmental and social costs of a project have been taken into account.

## Approaches to Change in PPPs

### Legal Considerations

The legal framework for undertaking modifications to PPPs will depend in the first instance on the terms of the agreement between the parties. These will typically include provisions on changes to services, and may also include certain events or timescales that will automatically trigger a review of terms. It is up to the public partner to be aware of the scope for changes under these terms, and to use the reviews to achieve more sustainable outcomes or savings wherever possible. The standardization of contracts proposed under PF2 includes a provision to allow more flexible service delivery, by pricing certain elective services (e.g., maintenance activities) in advance so that these can be moved in or out of the contract without triggering a rerun of the financial model. At the same time, the move to exclude soft services from long-term PPPs will help ensure public authorities have more control over these contracts. However, the overall scope for making adjustments to PFI deals based on sustainability considerations is not clearly set out in the standardized contracts or accompanying guidance.

In the European Union, the basic principles of transparency and competition derived from the European Union treaties come into play where adjustments to contracts are contemplated—as do the procurement directives.<sup>8</sup> In a series of cases,<sup>9</sup> the European Court of Justice ruled that certain modifications to contracts during their lifetime require a new competition to be held. While most PPPs fall outside the full application of the procurement rules, the European Commission has published guidance on the application of the Treaty principles to PPPs (Commission of the European Communities, 2007). This indicates that there is no general exemption for PPP arrangements from the rules on advertising and competition, but “double-tendering” is not required both at the stage where the PPP is set up and for the award of subsequent contracts to the project company, provided the contracts fall within the general scope of services and activities advertised at the outset.

What this means in practice is that public authorities have the ability to negotiate changes in contracts awarded under PPPs, unless these fundamentally alter the structure and purpose of the arrangement. This assumes that a competition has been held to appoint the private partner in the first place, rather than at the stage where the project agreement has been signed. While this leaves room to make changes linked to sustainability considerations during the lifetime of a PPP, it also restricts the effective bargaining power of the public partner, due to the lack of competition at this stage.

The European Commission’s communication makes clear that another possibility exists: a competition may be held at the stage where a public contract is being awarded to a public-private entity, rather than at the stage where it is being set up (Commission of the European Communities, 2007, p. 4). This would limit the scope of future changes to that contract, but may allow more effective comparison between the PPP route and other forms of service delivery—contributing to VfM assessment and getting the best deal out of private sector partners. This model may begin to make more sense in the United Kingdom as soft services are removed from the scope of PFI contracts, because separate competitions will need to be held for the award of these services in any case.

<sup>8</sup> Directives 2004/17/EC and 2004/18/EC of the European Parliament and of the Council

<sup>9</sup> See in particular Case C-496/99 P *Commission v CAS Succhi di Frutta* [2004] ECR I-03801 paras. 115–121; Case C-454/06 *pressetext Nachrichtenagentur* [2008] ECR I-04401, and Case C-91/08 *Wall AG v Stadt Frankfurt am Main*.

## Commercial considerations

As noted, in some cases a delicate balance will have been achieved between the interests of the public and private sector partners when setting up a PPP. However, that balance is inevitably achieved without full knowledge of future events—a risk that will be priced into the costs of the project. Once initial construction is complete, refinancing of PPPs on more favourable commercial terms is often possible. The PF2 reforms are intended, in part, to ensure that the public sector can benefit from any windfall at this stage, contributing to VfM and the economic sustainability of the project. However, at this stage it will be too late to address environmental and social impacts that are embedded in the design of the asset.

One way to address this problem is to designate a proportion of any windfall gains to an agreed list of environmental or social enhancements that can be implemented in the operational phase—for example, through energy-saving retrofits or the addition of renewable energy generation, setting up or enhancing a workers' pension fund, or opening up an asset to secondary uses. Private partners will often be keen to associate themselves with initiatives that will enhance their corporate social responsibility profile, provided this is at an acceptable cost to their bottom line. The presence of the government as a minority equity investor in future PF2 projects offers an opportunity for leadership on such initiatives.

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## Recommendations

1. Economic, environmental and social sustainability should be **core considerations** throughout the lifetime of a PPP. Where these have not been adequately addressed in the establishment of the PPP, or circumstances shift during the operational period, **public partners should seek changes**.
2. Economic sustainability should be assessed with reference to **VfM, private partner viability, investor returns** and **broader economic impacts** such as employment and taxation.
3. Environmental sustainability should be assessed with reference to **life-cycle impacts, mitigation, ownership of environmental issues** and **climate change adaptation**.
4. Social sustainability should be assessed with reference to **ethical working conditions and wages, impact on local communities** and maximizing **social returns**.
5. The **design** of PPP contracts and the **manner in which they are awarded** have a strong influence on sustainability, but there is also scope for later improvements, in particular linked to **midterm refinancing** and the application of any **windfall funds** once project risks have decreased.

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