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**The legal rules regarding PPP in an economic
perspective**

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The legal rules regarding PPP in an economic perspective

by

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Conference paper

Abstract

This paper focuses on the economics behind Public Private Partnership (PPP) and the legal frame regarding PPP. The Paper discusses the economic background for PPP, negotiation, co-operation and legal certainty. The paper uses the Coase Theorem as an application to explain a part of the economics of the PPP. Negotiation is a significant tool when making co-operation work in a PPP. The public procurement law does not allow negotiation and does not clarify PPP in a legal manner. This paper recommends a different approach in regard to legal certainty and legal rules on PPP. The paper concludes that a legal definition is necessary and that a specific public procurement procedure allowing negotiation is needed in relation to collaborative contracts such as PPP, and the paper presents some possible solutions to the problem.

1. Introduction to PPP

In a general legal context, a Public Private Partnership (PPP) can be characterised¹ as a long-term contract arrangement between a public authority and a consortium of private parties based on co-operation, aiming to provide a mechanism for developing public service provision involving significant assets or services for a long period of time.²

The asset or service is entrusted to the private sector, and a part or all of the funding comes from the private sector. The latter means that the private party in a PPP holds all equity and handles the works, operation and maintenance of the project.³ The PPP contract is, or at least should be, based on needs/functions instead of demands/concrete descriptions.

2. Economic explanation of the establishing the PPP concept

PPP was invented in the 1990s as a new method of public service and works delivery to improve the value for money and as a potential means of bringing private finance to the public sector.⁴

The basic idea behind a PPP contract can be derived from the economic effects of globalisation.⁵ The first problem established by globalisation was the cost of competing in a global arena due to the increased number of competitors. The cost of selling products on a global market increased, and the information technology costs also increased.

¹ See European Commission, *Green Paper on public-private partnerships and Community Law on Public Contracts and Concessions*. COM(2004)327 final, Brussels, 30.4. 2004.

² See OECD, *Public-Private Partnerships, in pursuit of risk sharing and value for money*, 2008, p. 22 for different permutations of PPP. In this book OECD defines a PPP as “an agreement between the government and one or more private partners (which may include operators and the financiers) according to which the private partners deliver the service in such manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners.”

³ See Sue Arrowsmith, *Public Private Partnerships and the European Procurement Rules: EU Policies in Conflict?*, (2000), 37 *Common Market Law Review*, 709-737, p. 709, and Sue Arrowsmith, *The Law of Public and Utilities Procurement*, 2nd ed., Sweet & Maxwell, London, 2005, p. 415. See also European Commission, *Green paper on public-private partnerships and community law on public contracts and concessions*. COM(2004)327 final, Brussels, 30.4. 2004.

⁴ United Kingdom and Australia were the first countries in OECD to set up this mode of service delivery. Now France, Germany, Ireland, Italy, Japan, Portugal, Spain, Turkey, Argentina, Brazil, South Africa, Poland, Denmark, Portugal, Hungary, Netherlands and several other countries have introduced PPP. See OECD, *Public-Private Partnerships, in pursuit of risk sharing and value for money*, 2008, p. 11 and Grimsey & Lewis, *Public-Private Partnerships, The worldwide Revolution in infrastructure provision and project finance*, Edward Elgar, 2007, p. 3-5.

⁵ Christina D. Tvarnø, *Public private partnership in the European Union*, *The New EU Public Procurement Directives*, ed. Ruth Nielsen and Steen Treumer (Ed.), pp. 183-194.

Globalisation makes it difficult to keep market power and market share. Because of the Internet, consumers have had access to all kinds of information and all types of products. A company no longer competes only against other companies within its own national sphere; it is now in competition with companies all over the world. Whatever their nationality, consumers have been receiving the same information, and they have wanted the same kind of life style and desired the same kinds of products; therefore, market conduct has changed.⁶ Companies started to find new ways to compete by entering into joint ventures and strategic alliances.⁷ Companies found new types of business strategies by creating the concept of co-operation. The companies could now ensure a higher quality in the product, decrease the cost of R&D, information technology, and sale and distribution, and increase their competitive capacity.

In the mid-1990s many governments experienced a pressure of fiscal deficits and an increasing public debt burden.⁸ At the same time the governments were facing a pressure to expand and improve public facilities and services.⁹ PPP was invented as a tool to implement EU policies and should fill the gap between the public needs and the need for financing.¹⁰ As mentioned above, the idea behind the PPP can be found in the private market contract arrangement as a result of globalisation. The private market already had experience in using strategic alliances to increase quality and decrease costs and by that the value for money. The motivation for making a strategic alliance was and still is to make a business arrangement that creates dynamism, collaboration and mutual learning among the parties. Therefore, initial agreements have less to do with success than adaptability to change in the market and in consumer needs.¹¹ Globalisation and the new business strategies created another need: a new type of contract. The PPP contract used today in the private industries of many Member States in the EU fills this need.¹²

The governmental attention to the market mechanism and the success of privatisation efforts in several countries increased the interest in PPP.¹³ The governments in the EU Member States faced the same problem as the private industries. Citizens in all the Member States demanded

⁶ Kenichi Ohmae, *The Global Logic & Strategic Alliances*, Harvard Business Review, March-April 1989.

⁷ Yves L. Dos and Gary Hamel, *Alliance Advantage, The art of creating value through Partnering*, Harvard Business School Press, Boston, Massachusetts, 1998, Preface, p. 9.

⁸ See OECD, *Public-Private Partnerships, in pursuit of risk sharing and value for money*, 2008, p. 11.

⁹ Grimsey & Lewis, *Public-Private Partnerships, The worldwide Revolution in infrastructure provision and project finance*, Edward Elgar, 2007, p. 19.

¹⁰ Michael Burnett, *Public-Private Partnership, a decision maker's guide*, Institut Européen d'Administration Publique, p. 1.

¹¹ Yves L. Dos and Gary Hamel, *Alliance Advantage, The art of creating value through Partnering*, Harvard Business School Press, Boston, Massachusetts, 1998, Introduction s. 15.

¹² Christina D. Tværnø, *Public private partnership in the European Union*, The New EU Public Procurement Directives, eds. Ruth Nielsen and Steen Treumer (Ed.), pp. 183-194.

¹³ Nutavoot Pongsiri, *Regulation and Public-Private Partnership*, International Journal of Public Sector Management, vol. 15, no. 6, 2002, pp. 487-495.

higher quality and better service, and at the same time a smaller tax bill. This was an economic challenge similar to the challenges in the private sector mentioned above.

The private sector met the consumer demand with new types of contracts including collaboration. The governments also had to find new ways of serving the citizens with higher quality, at the same time reducing taxes. Accordingly, PPP became relevant in the public contract area. In order to create a collaboration environment, a PPP contract is normally based on a high degree of trust, cooperation and interaction between the parties.

3. The market for PPP

In most countries the government is the biggest purchaser of goods of all kinds, ranging from basic commodities to high-technology equipment. At the same time, the political pressure to favour domestic suppliers over their foreign competitors can be very strong.

PPPs have received a boost in various countries undergoing a process of significant economic growth. By using PPP it is possible to provide additional capital, to set up alternative management procedures and implementation skills, to provide value added to the consumer and the public at large, and □to provide better identification of needs and optimal use of resources.¹⁴

The market for PPP and cooperation between the public and private sectors for the development and operation of infrastructure for a wide range of economic activities has increased. Years ago PPP arrangements were often driven by limitations in public funds to cover investments needs. Today PPP also is driven by the interest of increasing the quality and efficiency of public services in general.

PPPs are often used in infrastructure projects, e.g. in sectors such as technology, water, prisons, welfare, transport, public health, schools, urban regeneration and national security¹⁵ and provide a wide range of public services, like telecommunication, plants, financial support, innovative financing, general public services, education and research. Public-Private Partnership arrangements are made attractive by limitations in public funds and also by efforts to increase the quality and efficiency of public services.

PPPs have developed in part due to financial shortages in the public sector and have demonstrated the ability to harness additional financial resources and operating efficiencies inherent to the private sector.

¹⁴ See European Commission, *Guidelines for Successful Public-Private Partnerships*, March 2003, p. 4.

¹⁵ Grimsey & Lewis, *Public-Private Partnerships, The worldwide Revolution in infrastructure provision and project finance*, Edward Elgar, 2007, pp. 8-10.

4. The economic aim of PPP

A PPP must deliver infrastructures, buildings and services in a value for money perspective. This means that a significant aspect of establishing a PPP arrangement is that the output will be better than a similar traditional public project.¹⁶ Value for money means to reduce the cost and price, increase the quality, reduce the risks and failures, and improve the coordination and share responsibility and capacity. Those objectives result in a shift of content in the contract.

PPPs can achieve additional value compared with other approaches if there is an effective implementation structure and if the objectives of all parties can be met within the partnership between the public and the private parties.

There is a broad range of options for involving the private sector in the financing, physical development, and operation of transport and environment projects, traditionally run by the public sector.

In one type of PPP, the public sector may retain all responsibility for financing, constructing, operating and maintaining assets, together with the responsibility for assuming all associated risks. In another type of PPP, the private sector might assume all of these responsibilities. The vast majority of PPP approaches fall in the middle of spectrum, with risks and responsibilities shared between the public sector and its private partners according to their strengths and weaknesses.¹⁷

In the latter situation the private party is responsible for the funding, design, completion, implementation, service and maintenance.¹⁸ The incentive to build to reduce the cost of service and maintenance in the long run is changed because the PPP concept provides the contractor with a compelling reason to create the cheapest building or infrastructure for a period of 20 to 30 years.

Normally, a traditional public contract is based on demands and concrete descriptions. To fulfil the objectives the PPP contract focuses on needs and functions, and it must be built on trust, transparency by open books and co-operation between the parties.¹⁹

The European Commission has set up some reasons to establish a PPP project, which are: financing requirement in the environment, infrastructure and transport sectors, upgrade and extend networks in line with the accession requirements and effective service provision and

¹⁶ OECD, *Public-Private Partnerships, in pursuit of risk sharing and value for money*, 2008, p. 36

¹⁷ European Commission, *Guidelines for Successful Public-Private Partnerships*, March 2003, p. 13.

¹⁸ See European Commission, *Green paper on public-private partnerships and community law on public contracts and concessions*, COM(2004)327 final, Brussels, 30.4. 2004.

¹⁹ Another legal constellation in regard to PPP is the Institutionalised Public-Private Partnership (IPPP). IPPP will not be dealt with this paper.

financial shortfall in available public funds and the ability of international institutions to cover costs.²⁰

5. Joint utility in PPP

In a world of imperfect and incomplete contracts, it is still possible to gain some significant values from a PPP project structured in the right way.²¹ The benefits or advantages of setting up a well-functioning PPP are:²²

- Acceleration of infrastructure provision
- Faster implementation
- Reduced whole-life costs
- More optimal risk allocation
- Improvement of the incentives to perform
- Improvement of the quality of service
- Generation of additional revenues in the private sectors
- Transferring responsibility and enhanced public management
- Increasing investments in general
- Higher efficiency in the use of resources by joint utilities
- Generating commercial value from public sector assets by joint utilities

In the end all these factors can fulfill the main scope of a PPP agreement, which is to ensure joint utility between the parties, thereby ensuring the most efficient product at the lowest price.

The main priority of the PPP contract is to ensure the common utility by open books, trust, negotiation, needs instead of demands and sharing the responsibility. It is not possible to achieve the common utility – a better and cheaper product – unless the parties are allowed to negotiate and cooperate with each other.

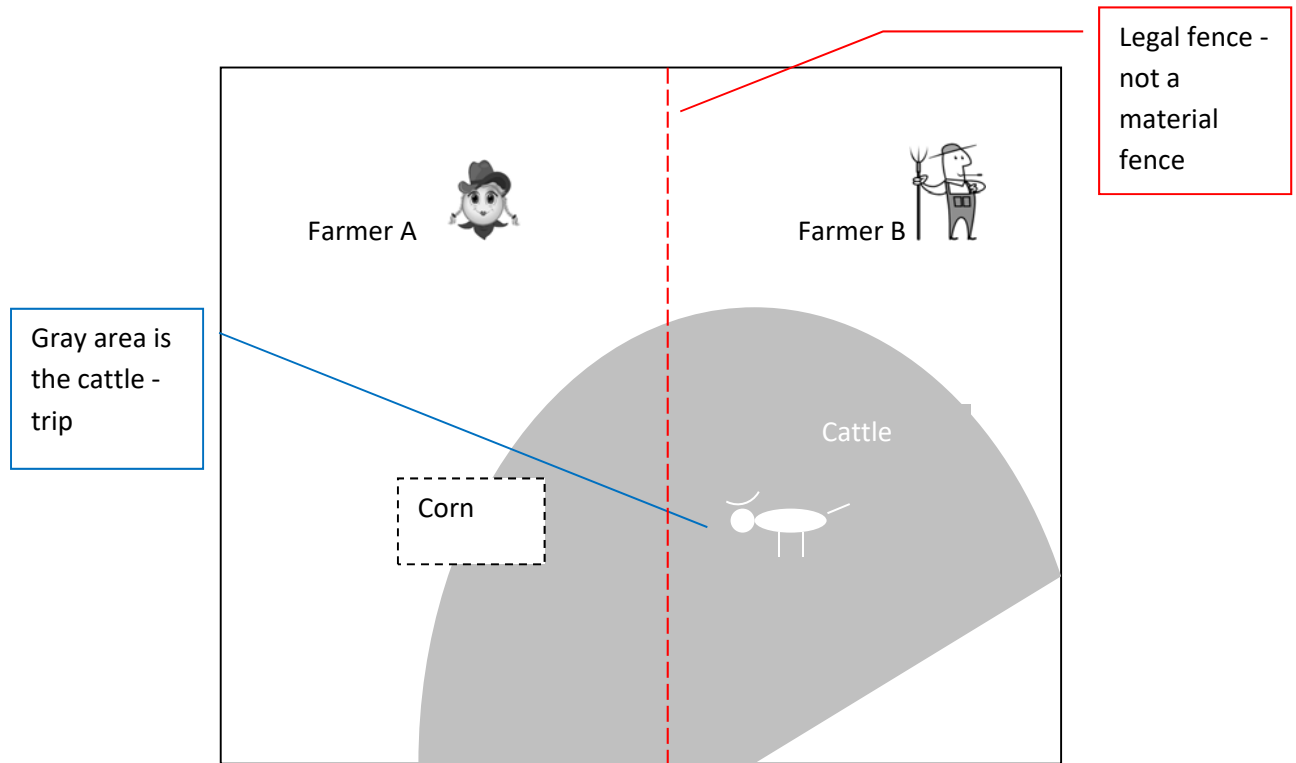
²⁰ See further OECD, *Public-Private Partnerships, in pursuit of risk sharing and value for money*, 2008, p. 35 and European Commission, *Guidelines for Successful Public-Private Partnerships*, March 2003, p. 15

²¹ See also Grimsey & Lewis, *Public-Private Partnerships, The worldwide Revolution in infrastructure provision and project finance*, Edward Elgar 2007, p. 247.

²² See also OECD, *Public-Private Partnerships, in pursuit of risk sharing and value for money*, 2008, p. 37 and European Commission, *Guidelines for Successful Public-Private Partnerships*, March 2003, pp. 15-16.

The first priority is to achieve the goal of common utility. The common utility can be explained by this following example:

Farmer A lives next to farmer B. Farmer A grows corn on some of her land and leaves some of the land uncultivated. Farmer B runs cattle on all his land.



Source: C. Tvarnø based on Cooter & Ulen, *Law and Economics*, 5. Ed., 2008, p. 88.

There is no fence between the two ranches, but the boundary is clear. Thus, from time to time farmer B's cattle wander into farmer A's property and damage farmer A's corn.

From a legal point of view, Farmer B would then have to pay farmer A for the damage of the corn. In regard to future damages, farmer B must build a fence around his land to keep the cattle inside his own property and by that ensure that future damage will not occur.

If instead the two farmers used another approach than the traditional legal solution, one could imagine a solution where the two farmers fell in love and got married. If then the farmers combined their business interests and maximized their joint profits, joint profits would be highest if they were to build a small fence around the cornfield. This would be the best value for money in this specific situation and the optimal joint solution.²³ If the farmers would not fall in love but were just neighbours deciding to negotiate the best value for money, the two farmers still could end up with a more efficient solution than the legal solution if they

²³ See further Cooter & Ulen, *Law and Economics*, 5. Ed., 2008, Pearson Education/Addison-Wesley, p. 88.

negotiated. This idea of negotiation is fundamental in regard to optimal contracts in for example strategic alliances, partnering contracts and PPP.

As stated above, more value for money requires that the parties negotiate and cooperate with joint utility in focus. By using the idea of joint utility, the purpose of a PPP contract is to:

- Reduce the cost and price
- Increase the quality
- Reduce the risk
- Reduce failure
- Improve the coordination
- Share capacity with the private party

By basing the contract on the needs of e.g. a school project, the public authority focuses on learning strategy, teaching environment, the differences in the learning abilities of pupils etc. This is different from a traditional contract between those kinds of parties. In a traditional procurement of a school building, the public party would instead focus on number of classrooms, number of square meters, types of furniture and facilities. In a PPP such reflections are left to the private parties.

The role of the economic operator, who participates at different stages in the project (design, completion, implementation, funding) is important and based on the core competences in the private sector. The public partner concentrates primarily on defining the objectives to be attained in terms of public interest, quality of services provided and pricing policy, and it takes responsibility for monitoring compliance with these objectives.

The distribution of risks between the public partner and the private partner is different. The risks generally borne by the public sector are transferred to the private party if this is efficient in regard to the transaction and the project.²⁴ A well-functioning PPP is highly reliable on the possibility of setting up the incentive structure in the right way. One part of a workable incentive scheme is when the supplier bears the right amount of risks, on the ground that those with money at risk have an incentive to make efficient decisions.²⁵ The parties are the closest to negotiate the risk and the value of this risk. If the public party in the tender notice already sets up the distribution of the risk as demanded in public procurement law, the project cannot create the best value for money.

²⁴ The Commission notes that a PPP does not necessarily entail that the private partner assumes all the risks, or even the major share of the risks linked to the project. The precise distribution of risk is determined case by case, according to the respective ability of the parties concerned to assess, control and cope with this risk.

²⁵ See also Grimsey & Lewis, *Public-Private Partnerships, The worldwide Revolution in infrastructure provision and project finance*, Edward Elgar, 2007, p. 247.

6. PPP in a public procurement law reality

PPP contracts will normally fall under the scope of public procurement law. Neither international law as WTO or INCITRAL, nor national legislation²⁶ nor the EU has legal public procurement rules that specifically cover the PPP arrangement in regard to public contracts rules.

Thus, since the EU public procurement law does not specify concrete PPP rules and definitions, barriers to the use of PPP in the aim of an alternative and more efficient procurement model can be a serious reality.

The EU public procurement law is based on the common market and the elimination of barriers to trade in goods between Member States and barriers to movement in business, labour and capital.²⁷

The political and economic reasoning behind the common market is based on the economic theory of comparative advantages.²⁸ The purpose of the public procurement law is to ensure an opening up of the public procurement market.²⁹

The public procurement law has several objectives: one is the possibility to eliminate a corrupt governmental practice; another is that effective public procurement is essential for good public services and good government. The procurement rules ensure that the government applies the highest professional standards when it spends money on behalf of taxpayers.

This procedure helps to ensure competition as the cornerstone of public sector procurement and to maintain market interest – particularly where a well-established and competitive market does not already exist. In markets with no or limited competition, the procurement rules can undertake market soundings, be prepared to adapt the requirements to the capacity and

²⁶ A few countries have enacted specific national rules covering PPP: Brazil enacted a PPP act in December 2004, designed to encourage investments for crucially needed infrastructure projects. See Law No. 11.078, D.O.U.31 Dec., 2004 and also C.V. Filho and J.B.Lee, *Brazil's New Public-Private Partnership Law: One Step Forward, Two Steps Back*. *Journal of international Arbitration* 22(5):419-426, 2005.

²⁷ Thus, a public contract depends on the respect of the procurement rules, the respect of the fundamental principle of competition concerning equal access to the market, the ban on anti-competitive agreements, and economic and financial equilibrium of the projects.

²⁸ See Krugmann and Obstfeld, *International Economics, Theory and Policy*, Addison-Wesley, 6th ed. 2003, part I.

²⁹ The public procurement rules apply to purchases by public bodies. The public procurement Directives set out the legal framework for public procurement. The legislations, directives and model laws apply when public authorities and utilities seek to acquire goods, services, civil engineering or building works. The importance in regard to PPP is that the principles in the public procurement law set out rules and procedures which must be followed before awarding a PPP contract; see also Sue Arrowsmith, *The Law of Public and Utilities Procurement*, (2nd ed., Sweet & Maxwell, London, 2005), p. 121, Christopher H. Bovis, *EU Public Procurement Law*, Elgar European Law, 2007, p. 52 and Michael Burnett, *Public-Private-Partnerships (PPP) – A Decision Maker's Guide*, Institut Européen d'Administration Publique, Maastricht.

capabilities of the marketplace, and advertise and market contracting opportunities as broadly as possible.

Other objectives of the public procurement law are to ensure fairness and equal treatment, better procurement practices, open up the competition and lower the overall prices. The basic principles to obtain these goals are transparency, non-discrimination, equal treatment, proportionality and competition.³⁰

The lack of rules and definitions might create barriers that increase the transaction costs in connection with the public procurement of PPP projects. PPP can provide a significant economic advantage, and beside the existing objectives regarding transparency and equal treatment the EU public procurement rules should also address the economic efficiency of PPP.

The main priority of the present legislation is equal treatment, transparency and free movement, all fundamental principles in the European Union. But the citizens, the private parties and the public authorities must also be given the possibility to achieve the most efficient agreement and outcome of a PPP.

Hence, the principles of the procurement rules are to ensure competition, equal treatment and transparency, but not co-operation. Instead, there is a general legal ban on negotiation.

Shown by the economic theory above, a PPP contract can be optimised by the use of negotiation. If negotiation is not present in the contracting period, it can be difficult if not impossible to gain better value and lower cost. If the parties were to use the common legal solution instead, the risk would be that the legal solution will point out a less value for money solution since economic theory can prove that the parties are the best when it comes to negotiating the joint utility.

Public procurement law does not define the content of the PPP contract. PPP is covert but not defined by the public procurement rules. At the same time the parties cannot negotiate the terms of the contracts as freely as two private parties. The public procurement regulation and the tender procedures set restrictions to a negotiation similar to private contracts.

The conclusion is that the lack of a legal definition and the ban on negotiation prevent significant positive gains from PPP.

Public procurement law in the EU, WTO and UNCITRAL is an instrument to ensure a competitive market discipline. Public procurement law is a necessary regulation in imperfect markets. The problem arises when the competitive objective outranks the economic benefits of cooperation and negotiation in PPPs.

³⁰ The EC procurement law is not only used by the 27 EU Member States. The EU public procurement rules also apply to a number of other countries because of an international agreement negotiated by the World Trade Organisation (WTO) titled the Government Procurement Agreement (GPA). In regard to PPP the legal situation in all Member States is that PPP is a public contract falling within the scope of the public procurement law. This is Aruba, Canada, Hong Kong, China, Iceland, Israel, Japan, Republic of Korea, Liechtenstein, Norway, Singapore, Switzerland and USA.

7. Conclusion

It is necessary to acknowledge that two key elements in a PPP are negotiation and co-operation between the private and public party. However, the procurement rules in general require that the public party in the tender procedure sets up almost all conditions, and only minor matters can be changed after the award.³¹

It can be argued that since co-operation and negotiation are such an important aim of the PPP, problems arise because the EU, the UN and the WTO procurement rules do not ensure this co-operation. Hence, the principles of the procurement rules are to ensure competition, equal treatment and transparency, but not co-operation.

The access to negotiation, co-operation and clear legal rules in relation to PPP must be ensured by the legal system. These are necessary elements to establishing efficient PPP arrangements.

The aim of specific PPP rules must be to enhance legal certainty and avoid that the legal environment facilitates opportunistic behavior. Also, legal certainty may alleviate the concerns that traditional procurement rules might make PPPs unattractive or impossible to carry out.

A simple solution is to set up specific PPP rules in the public procurement regulation – both in the EU and WTO - and legally define exactly what a PPP is, how a PPP has to be set up, how to ensure a fair and transparent competition when selecting the private parties, and how to run a PPP.

When this is accomplished, the PPP can use a different tender procedure acknowledging the special aim of the PPP described above in this paper. Thus, the public service can be operated on market conditions with the benefits related to the market, and the co-operation can be prioritised. The well-known negotiation procedure in the EU utility directive could be a solution.

While subject to special procedural procurement rules, the PPP rules should allow the special turnaround in the traditional incentive procurement structures necessary for PPP. PPP has the potential of achieving greater economic efficiency by changing the incentive structure of co-operation.

³¹ See further Simon Everts Hjelmberg, Peter Stig Jakobsen and Sune Troels Poulsen, *Public procurement law – the EU Directive on public contracts*, Copenhagen, 2006, p. 201.