# Chapter 31
# Managing Risks of Public-Private Partnerships

## 1.0 Main Points

Public-private partnerships (P3s) are a type of public sector procurement. They include a broad range of arrangements where a government works with the private sector to deliver infrastructure and provide related services. The use of P3s involves risks that must be managed. These include risks related to:

- Accountability and transparency
- Capacity
- Assessment
- Meeting government and user needs
- Risk transfer to private sector
- Innovation
- Sustained monitoring

If a government does not effectively manage these risks, it may pursue a P3 in an area unsuited for its use, make a bad contract with its private sector partners, not achieve its objectives, or not obtain value for money. This chapter presents best practices for managing these risks. We encourage government agencies to consider these best practices when looking at the use of P3s and entering into P3 arrangements.

## 2.0 Introduction

In our *2001 Fall Report – Volume 2* (Managing Accountability Risks in Public-Private Partnerships, Chapter 4), we outlined best practices for managing accountability risks associated with entering into P3 arrangements.[1] The purpose of this chapter is to build on our 2001 work by setting out best practices for managing risks specific to P3s. The focus of this chapter is on risks specific to P3s, as opposed to risks common to both P3s and other types of purchasing decisions, or risks that are part of complex contractual arrangements in general. Managing risks of P3s is important because P3s can be of significant economic and social importance.

[1] The Report is available at www.auditor.sk.ca.

# 3.0 Background

## 3.1 What are P3s?

Public-private partnership (P3) is a term used to describe a broad range of arrangements where a government works with the private sector to provide services (usually in the area of infrastructure) that have traditionally been delivered by the public sector.[2]

The relationship between the public and private sector in these arrangements can vary greatly. The key as to whether an arrangement between a government and the private sector is a P3 is the nature and extent of private sector involvement. When people describe P3s, they often refer to different possible components or phases of a project, such as design, build, finance, operate, and maintain. In a P3, the private sector can be involved in several or many of these phases and usually over an extended period.[3]

P3s typically seek to:

- Focus on the overall outputs or outcomes to be achieved
- Allocate risks (such as the risk of late construction completion or cost overruns) between the government and the private sector partner[4]
- Gain benefits from the integration of multiple phases into one larger project (for example, the same partner both designing and then maintaining a facility would be expected to design it to enable efficient maintenance) or integration of multiple projects (for example, using the same partner on several similar projects)

## 3.2 Increased Use of P3s by Governments

Governments use physical assets to provide services. These assets, including roads, bridges, buildings, and other types of assets are called "infrastructure." Infrastructure deteriorates without appropriate or sufficient maintenance. If governments do not sufficiently invest in building and maintaining infrastructure, for example because of competing or more immediate priorities, a growing infrastructure gap or deficit can result. That such a gap exists in Canada is "widely recognized."[5] As it becomes increasingly expensive to address infrastructure deficits, governments have turned to non-traditional procurement methods, including P3s.

The provincial government has stated its intention to consider alternative methods for developing infrastructure, including the use of P3s.[6] On October 17, 2012, the Government of Saskatchewan established SaskBuilds as a Treasury Board Crown corporation. SaskBuilds "is the lead central agency responsible for prioritizing, planning and coordinating infrastructure projects." It is also responsible for advising on "…the

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[2] Provincial Auditor of Saskatchewan, *2001 Fall Report – Volume 2*, Chapter 4, p. 40.
[3] For a more extended description of what constitutes a P3, see Auditor General of British Columbia, "Understanding Public Private Partnerships" available at www.bcauditor.com.
[4] For simplicity, this chapter refers to a single partner, although groups of private sector companies are common. Also, the words "partner" and "partnership" are used in a general, not legal, sense.
[5] See, for example, Library of Parliament, "Current and Emerging Issues—41st Parliament". www.parl.gc.ca/content/lop/researchpublications/cei-24-e.htm (27 September 2013).
[6] Government of Saskatchewan, *Saskatchewan Plan for Growth*, p. 4.

most effective and appropriate methods for advancing infrastructure projects including public-private partnerships."[7]

The October 23, 2013 *Speech from the Throne* noted that "SaskBuilds is working with government ministries on the development of new schools, the new Saskatchewan Hospital in North Battleford, a new long-term care facility in Swift Current and the Regina Bypass project."[8] The Government also stated that "P3s will allow the government to advance certain capital projects more quickly while reducing costs."[9]

## 4.0 Managing Risks Specific to P3s

Public sector procurement always presents risks and challenges that a government[10] must manage. P3s present additional risks and challenges that must be well managed. If a government does not manage these risks, it may pursue a P3 in an area unsuited for its use (e.g., an area characterized by rapidly changing technologies where long-term contracts are not ideal), make a bad contract with its private sector partner, not achieve its objectives, spend too much, or not obtain value for money. As with other types of procurement, effective contracting is of key importance.

To identify additional key risks and challenges associated with P3s and related best practices to manage them, we examined current literature on P3s including the work of other legislative auditors (see **Section 5.0**). We have grouped these risks into seven categories: accountability and transparency, capacity, assessment, meeting needs, risk transfer, innovation, and sustained monitoring. In this section, we describe each of these key risks and outline best practices for managing them (see **Figure 1**).

**Figure 1–Best Practices for Managing P3 Risks**

1. **Accountability and Transparency**
   - Establish framework in legislation or policy for use of P3s
     - Set out objectives and principles for use and governance of P3s
     - Set policies and processes for:
       - Identification
       - Evaluation
       - Selection
       - Approval
       - Access to and reporting from private sector partner
       - Management and coordination
       - Oversight
     - Specify public reporting requirements
2. **Capacity**
   - Maintain adequate capacity to:
     - Identify possible areas for use of P3s
     - Evaluate potential P3s, including analysis of alternatives
     - Identify risks
     - Analyze financing implications
     - Negotiate contracts that achieve government objectives and appropriately assign risks
     - Inspect and monitor performance of private sector partner for lifetime of project

[7] SaskBuilds, *2012-13 Annual Report,* p. 4-5.
[8] Government of Saskatchewan, *Speech from the Throne 2013*, p. 8.
[9] Ibid.
[10] "Government" can include different levels of government or individual government agencies.

**3. Assessment**
- Establish criteria for identification of areas where P3s will be considered
- Require careful analysis and approval of business case:
  - Stating clear objectives and outcomes
  - Describing nature and extent of government involvement
  - Evaluating costs, benefits, and risks over lifetime of P3
  - Showing risk allocation
  - Analyzing financing
  - Setting out alternatives to P3
  - Stating key assumptions
  - Including baseline performance information
  - Addressing policy implications

**4. Meeting Government and User Needs**
- Identify required functionality and all intended uses
- Ensure functionality and intended uses are reflected in business case and contract

**5. Risk Transfer to Private Sector**
- Identify risks related to performance and results of P3
- Ensure risks are documented in business case
- Assign risks to partners to match requirements of business case

**6. Innovation**
- Carry out early assessment of private sector interest in P3
- Structure procurement to allow proposal of innovative solutions

**7. Sustained Monitoring**
- Require appropriate reporting
- Monitor compliance with contract requirements
- Manage changes and disputes
- Apply penalties/incentives

## 4.1 Accountability and Transparency Risks

Working with private sector partners to develop projects and deliver related services does not lessen a government's accountability in any way. Governments remain ultimately accountable and answerable for the delivery of the goods and services, and the use of public resources.

The involvement of a private sector partner can affect the transparency and accountability of P3s. Private sector partners may be reluctant to share information with the public regarding a project's status, cost, and performance, citing concerns about the impact on their competitiveness or the disclosure of proprietary information. Because a private sector partner is often the visible face of a project or service, the continuing ultimate accountability of a government can be obscured.

Also, P3s often involve multiple government agencies. This increases the risk that there will be uncertainty about the nature and extent of the accountabilities of each of the various government agencies.

To manage accountability and transparency risks, a government should establish a framework in legislation or policy for the use of P3s. The framework would:

- Set out overall objectives, principles, and policies for the use and governance of P3s.

- Set out processes for identification, evaluation, selection, and approval of P3 projects (in addition to the processes used for all procurements). Approval requirements for P3s (responsibilities and steps) would help ensure that P3s are authorized by individuals with appropriate authority.

- Require adequate reporting from and access to the private sector partner. A government must ensure it has the ability to monitor and inspect (including the ability by the government and its auditors to access books and records of the private sector partner).

- Require clarity as to who is accountable to whom and for what. Where multiple government agencies are involved, a single government agency should be responsible for coordination and oversight.

- Require public reporting. Good reporting of a P3 would reflect the significance of the project. Periodic public reports would provide public transparency on key processes, results, and costs for the P3. Reports would disclose the full costs of the P3 across all participating agencies and components of the project, including all assets and liabilities, and would cover the entire lifetime of the project (total lifecycle costs).

## 4.2 Capacity Risks

P3s often involve complex or sensitive matters and large costs. P3s also present particular risks because of the involvement of multiple parties both within and outside of the public sector, the long periods they cover, and the multiple project phases typically involved. Also, at times, governments enter into P3s to access specific expertise of the private sector (e.g., construction of specialized buildings).

If governments overlook their ultimate accountability and think that they can outsource their responsibility to make informed decisions and oversee P3s, they may neglect to ensure they have the knowledge, skills, and ability (i.e., capacity) to make informed decisions during the various phases of the P3 (i.e., planning/transaction, design and construction, and operating). Governments must include the cost of building and maintaining this capacity into their analysis supporting their business plans (see **Section 4.3**) and future resourcing decisions.

To manage these risks, a government must have adequate capacity when deciding to enter into a P3 and for managing a P3. It must maintain adequate capacity in the technical areas involved in a project as well as in financial, legal, and procurement areas. An absence of capacity may result in a government, for example, deciding to use a P3 approach where not warranted, negotiating a poor contract or one that does not meet its needs, or not adequately monitoring the performance of the private sector partner.

For a government to undertake a P3, it requires adequate capacity to:

- Carry out a careful, thorough evaluation of the use of a P3 approach, compared to alternatives

- Identify risks associated with entering into and managing a P3

- Analyze financing implications including consideration of financial proposals

- Negotiate a contract that achieves the government's intentions and appropriately assigns risks between the partners

- Inspect and monitor performance of a private sector partner (i.e., in the delivery of the infrastructure and related services) for the lifetime of the project

A government must ensure that it sustains the capacity required to monitor a P3 throughout all of its phases. The government must actively inspect and monitor the P3 during its design and construction phases, and must also actively monitor service delivery and maintenance performance during the operating phase of the project.

## 4.3 Assessment Risks

A government must be prepared to explain its reasons for selecting a P3 procurement approach. Because of higher levels of public interest and scepticism surrounding the use of P3s, a government faces increased expectation that it can demonstrate to the public that use of this type of procurement for a project provides clear advantages.

To manage these risks, a government should describe clear criteria and processes, set out in the framework described in **Section 4.1**, that it would use to screen possible areas for private sector involvement and use of a P3 approach.

For specific projects, a government should require careful analysis of potential P3 projects through development of a comprehensive and supportable business case for each project. The business case for a proposed P3 should:

- Set out clearly-defined objectives and desired outcomes for the P3. These should match the government's identified needs specific to the project.

- Set out which stages of the P3 the private sector would be involved in, along with the nature and extent of involvement.

- Include an evaluation of costs, benefits, and risks over the entire lifetime of the P3. Costs should include total lifecycle costs for the project,[11] including transaction costs[12] (which because of the complicated contractual arrangements are typically higher for a P3 than for a conventional procurement), operating/maintenance costs, and financing costs. Costs should include costs of maintaining appropriate expertise—technical, financial, legal and procurement—to effectively assess costs, benefits, and risks.

- Show how risks are to be allocated between the government and the private sector partner (see **Section 4.5**).

- Analyze project financing including implications for accounting and key financial indicators (e.g., debt/equity ratios, net debt).

- Explicitly set out alternatives to a P3. The consideration of alternatives must include preparation of a "public sector comparator" or "value for money assessment." These are a detailed comparison of delivery of the project using a P3 to using conventional procurement processes to identify if there are advantages to using a P3.

[11] Total lifecycle costs means all costs, for all phases, over the entire lifetime of a project, i.e., from proposal through evaluation, construction, operation and decommissioning.
[12] Transaction costs are the costs of planning, negotiating, and entering into the contracts that create a P3, including legal, financial and technical expertise.

- Set out key assumptions used in the analysis and their basis. Assumptions should be consistently applied to all considered alternatives.
- Gather information about performance of existing functions to ensure there is a baseline to evaluate future P3 performance of the same or similar functions.
- Address the policy implications of using a P3. Due to issues relating to socioeconomic, environmental, legal, health, or privacy matters, the involvement of private sector partners may not be feasible or could be limited in some ways. A government should consider consulting with stakeholders in exploring these issues.

Overall, the business case should clearly present an analysis that examines the advantages and disadvantages of the use of a P3. A project should not proceed if the disadvantages outweigh the benefits.

The business case should be prepared by staff with appropriate expertise and be approved by appropriate authorities, including senior management and the governing body responsible for the project.

## 4.4 Risks Related to Meeting Government and User Needs

As noted under **Section 4.3**, a government needs to have clearly-defined objectives and desired outcomes for the P3 project. If a government does not do an effective job of analyzing and setting out its current and future needs as it plans for the use of a P3, it risks not meeting those needs. Planning to meet user needs for infrastructure for the long period covered by P3 agreements (agreements can extend 10, 20 and 30 years) can be difficult. Changes can affect the assumptions supporting the original decisions on how to proceed.

To manage these risks, a government must carefully identify future uses of the infrastructure. Consultation with users and stakeholders would assist in completely identifying uses. The business case must reflect these uses, as must the contract the government later negotiates with a private sector partner.

## 4.5 Risk Transfer to Private Sector

One of the defining features of a P3 is risk transfer. In a P3, a government will seek to transfer certain risks (e.g., construction delay) to a private sector partner. The overall costs of the project to a government reflect a private sector partner assuming specific risks.

If a government does not do an effective job of identifying risks and transferring specific ones to the private sector, it risks unintentionally assuming the risks itself, and paying too much to a private sector partner. Also, it may not be feasible or cost effective to transfer some risks.

To manage the risk of ineffective risk transfer, a government must completely identify risks related to the performance of obligations under the P3 project. The costs and proposed allocations of the risks should be documented in the approved business case.

These risks must be revisited and updated throughout the planning phase. The government must also assess the capability of the private sector partner to assume risks for the life of the project. Once the P3 project is approved, a government must negotiate a contract that clearly assigns the risks between the partners as set out in the final approved business case.

Sustaining adequate capacity, as described earlier, is crucial to help ensure that risk transfer is effective for the entire lifecycle of the project and survives contract changes (see **Section 4.7** regarding management of changes).

## 4.6 Innovation Risks

Another defining feature of a P3 is the intent, by focusing on the overall outputs or outcomes to be achieved, to permit a private sector partner to propose innovative solutions to address government needs. If a potential project is not designed to attract private sector interest, there is a risk that the project will not result in competitive proposals. Further, if a P3 procurement is not designed to permit innovative solutions to be proposed, the risk is that a government will miss an opportunity to achieve its objectives in a cost-effective manner.

To manage these risks, a government must assess, early in considering use of a P3, whether there will be sufficient private sector interest in participating in a P3. If this is not the case, the use of a P3 should be reconsidered. A government should structure the procurement to permit the proposal of innovative solutions (e.g., for design, operation, outputs, risk transfer or financing).[13]

## 4.7 Risks Related to Sustained Monitoring

A government has to effectively monitor the performance of its private sector partner to assess whether infrastructure and related services provided under the P3 are meeting its expectations. It must take timely corrective actions or mitigating steps to address non-performance or substandard performance.

Monitoring can be more difficult because of the long periods covered by P3 agreements. As noted above, changes can affect the assumptions supporting earlier decisions. If effective monitoring does not take place over the entire project life, there is increased risk that the P3 will not meet user needs and that the government will not receive value for money.

To manage these risks, a government must monitor effectively through:

- Inspection and verification that services are taking place
- Review and analysis of reliable reports and performance data from the private sector partner

As noted earlier, effective monitoring and inspections throughout all the phases of a P3 require a government to maintain sufficient capacity. This may require a government to engage an additional party to assist it in its monitoring role.

[13] National Audit Office, *A Framework for evaluating the implementation of Private Finance Initiative projects: Volume 2*, p. 17.

Over the extended period of a P3, there is risk of significant change. The contract should provide a process for promptly addressing changes. Contract changes should receive appropriate approvals before proceeding and should consider the impact of the changes on the original assessments supporting the choice of using a P3 and the intended transfer of risks. The contract must also include a mechanism for dealing fairly and expeditiously with disputes.

If a private sector partner's performance does not meet expectations, penalties should be applied in accordance with the contract. Performance incentives should also be applied as agreed upon.

## 5.0 Selected References

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