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# Public-Private Partnerships: Navigating the Waters in Latin America

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A public-private partnership, or PPP, is a complex legal and political relationship. Many countries in Latin America have been innovative leaders in creating PPP frameworks. They have successfully attracted private capital to build and operate efficient new infrastructure projects, with particular successes in Chile, Mexico, Brazil and Colombia. Yet, progress has been neither universal nor consistent. Knowing a few basic characteristics and legal principles about PPPs can help to create a more stable, sustainable and mutually beneficial partnership, serving the overlapping interests of private sponsors, lenders, governments and the public.

From the private investor's standpoint, one of the keys to a successful PPP is to know the legal framework in which the public entity is operating and to negotiate accordingly. This is particularly true in Latin America, where the structure of government, laws and business practices vary from country to country and state to state.

Chile, for example, has a model framework for a successful PPP relationship. Concession rights there are generally composed of three key elements: 1) a law that enables the government to award a PPP concession to a private company and sets forth the requirements for that relationship, 2) a new association document—basically, a request for bids—which includes bidding rules and guidelines for the particular project, and 3) the contract, signed by the winning bidder. Together, this bundle of rights establishes the rights and responsibilities of the concession holder and the relevant government agencies with respect to each facility (i.e. an airport, toll road or port).

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There are three characteristics of Chile's concessions that are critical to any successful PPP agreement, regardless of the specific legal model by which the concession is implemented: transparency, predictability and accountability. With transparency, the concession rights and bid award process are clear, and bidding requirements and contract terms are public knowledge and are applied consistently among all bidders. Predictability ensures that the private sector can know exactly what its rights and responsibilities are, and can price them accordingly. Removing or reducing uncertainty reduces costs, benefitting users and investors alike. Accountability is important so that the government through the concession can enforce uniform standards,

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performance benchmarks, project deadlines, investment amounts, safety and operating standards, and handback requirements.

Brazil, where there are both federal and state PPP concessions, has created a slightly different legal framework. Nevertheless it is also a stable and reliable system, designed to serve the same goals of transparency, predictability and accountability. Some Brazilian states have their own laws governing PPPs, while others don't. In fact, a few of the states were actually even ahead of the federal government in the development of PPP laws and standards.

We are sure to see more creative PPP structures arise in Brazil. The need for greater private investment in public infrastructure is immense, and the market is widely viewed as attractive for these types of investments. Many of these relationships are forming not just for transportation (i.e., roads, rail and transit systems), but also for things like sports stadiums and related facilities for the upcoming World Cup games and the 2016 Olympic Games in Rio de Janeiro.

A prerequisite for PPP activity is a law that enables private entities to perform services that ordinarily would be done by the government itself. However, some Latin American countries don't have such enabling statutes. In those cases, a private investor who is interested in forming a PPP may be able to approach the government with an unsolicited proposal to create a framework from scratch. Unfortunately, this approach typically doesn't have the transparency, predictability and accountability that we look for in most successful PPPs, so the outcome is not entirely predictable. As such, success is far from assured and costs may be considerably higher.

Any private investor who is interested in entering into a PPP in Latin America outside its home market must have good local advisors who know the country and its laws. The PPP process and the substance of concession laws vary so much among countries and states that it would be unadvisable to enter into a relationship with any government without good local counsel. It is wise to focus on commercial projects with the most predictable government support. This is particularly advantageous in markets where strong local partners are available.

Another factor to investigate—one that also varies widely from country to country—is the existence of laws that cap the rate of return allowed to investors. Caps are, in part, political. The government may fear that the private sector will make too much money on the PPP, or there may simply be fear of the private sector to start with. Governments worry that the private investor will create a lucrative operation and then gouge the public, when they should be providing the service for an affordable price.

However, if the rate of return is capped too low, the private sector won't take the risk. That wastes one of the advantages of PPPs for governments: shifting risk—construction, finance, operations and so forth—from the public sector onto the private sector. In return for taking on those risks, private-sector partners need to be compensated. They also would like incentives to minimize the cost of the project and to create more revenue through creative marketing. If the rate of return is capped too low, there are no incentives. Ideally, rather than a set cap on return, concessions contain revenue sharing once a target return is reached. This preserves the concessionaire's profit incentive while preventing an unfair or politically unsatisfying windfall.

A similar issue relates to setting tolls, tariffs or other user fees, which can be politically sensitive. Take for example a PPP to construct a toll road. The decision on the amount of the toll is a political question as well as an economic one. If the toll is set too low, the private operator won't be able to recover its costs and service its debt, so the government will likely have to pay a subsidy of some kind. On the other hand, if the government allows the tolls to be set too high, and they exceed the amount needed to cover the operator's costs and reasonable return, then the project may not be politically sustainable or popular with users.

A capped rate of return (aided by the maximum the public will tolerate) would prevent tolls from being set too high. However, if the cap is too low for the investor to recover its costs, the net effect is to chill the market and discourage other investors in the future.

Most PPP concessions govern how tolls or fares are set. Initial tolls or fares are usually spelled out in the contract. The rate mechanism should be flexible, but it should include an overall cap on how quickly the toll or fare amounts can rise. Specifically, the private concession company may want to restrict the government's right of approval over every toll increase, since revenue flexibility to optimize capacity is one of the advantages of PPPs. The government, however, will not want the private-sector partner to have carte blanche to do whatever it wants with the tolls or fares.

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A way to resolve this conflict is to agree that toll rates or fares may never exceed the amount of the initial rates indexed for inflation, while preserving for the private concessionaire the right to modify rates below those limits and for special circumstances, such as time of day and amount of traffic congestion. A higher price during congested periods also tends to derive more efficient use of the asset. So charging motorists more to use the road during rush hour would shift traffic onto the less-busy times of the day, which creates a more efficient system and increases capacity overall, reducing the need for costly new public improvements and providing ancillary benefits from congestion relief.

Along with—and influencing—the legal issues of PPPs are financial and budgetary considerations. From the beginning, one key hurdle is to prove, quantitatively, that the proposed PPP adds value to the public, compared with other options for accomplishing the goal. One such option is simply not doing the project at all. In reality, however, that's rarely the ideal option in a developing region like Latin America.

Another scenario for comparison is the government taking on the same project alone, building it with public money instead of private investor money. One of the arguments for PPPs is that they typically help to control construction budgets—spending on government building projects tends to balloon out of control, while private-sector projects are incentivized to control costs. So while initial bids from private concessionaires tend to be higher because they are required to bid on a fixed-price basis, they can often complete the project at a lower cost—and more quickly than the government can.

**It's helpful to make the distinction between PPPs that develop and operate new assets—often known as greenfield projects—versus the PPPs that are formed to operate existing—or brownfield—assets. Mexico has recently tried to combine these two formats.**

Private investors typically have a higher cost of capital than the government does. In that case, the government is probably not getting a lot of extra value from having the private sector take on the financing. However, the analysis shouldn't stop there. Since the government has a finite amount of resources to fund its full range of projects, it might not want to use all or a significant portion of its resources on a single project. So entering into a PPP with its most "commercial" project—even if the overall cost is higher—frees up those limited public resources for other projects or public programs.

One of the most important—but also most often overlooked—considerations for a PPP versus a government-only approach is the quality of the project itself. There are two aspects of this consideration.

First, private operators tend to deliver good user experiences and safe projects because they have a profit incentive to create a facility that lots of people will use and because they can focus on one specific project at a time. In contrast, the government often doesn't have as great an interest in maximizing traffic or ridership or in enhancing the subjective facility quality and efficiency beyond mere capacity additions. Therefore, the government project may not be of the same quality as a private concessionaire's project.

There is a further value-for-money benefit in a PPP, in that the government gets an asset that is usually well maintained throughout its lifespan. A PPP contract typically includes requirements that keep the private partner accountable to a certain standard of maintenance. In order to meet that standard, the concessionaire is constantly reinvesting a portion of the project cash flow.

As a result, when the asset returns to the government at the end of the concession term, it's in like-new condition. In contrast, when the government builds something, the level of maintenance is typically much lower. So after 30 years or so, the structure has to be rebuilt. Public projects are not subject to the accountability and contractual standards of a private concession nor to other legal requirements that would compel the same level of investment over the operating life of the asset to prevent deterioration and obsolescence.

Another key factor in the success of a PPP is to eliminate ambiguities wherever possible. It is, for example, important to delineate the specific roles for both the public and the private partners and determine how the partnership can add value to both sides of the relationship. A PPP is different from the government simply entering into a design/build contract with a private contractor. By shedding risk to the private sector, the government realizes economic and non-economic benefits. In the PPP, the private partner takes on some or all of the risk, such as financing, building and operating a project or operating and maintaining an asset that is being privatized.

An example of this, and one of the first PPPs in South America, is the expansion of Chile's Santiago International Airport in the late 1990s. If the government had simply hired a contractor for the job, it would not have been considered a PPP because the private sector would not have been assuming any of the risk of the project.

Instead, the Chilean government entered into a PPP with a company to construct the expansion and operate the landside aspects of the airport (e.g., operating and maintaining terminals, managing food and retail operations, coordinating with airlines for passenger processing and cargo operations, parking and airport hotels). The private partner was assuming risk, but it was also incentivized to do well in order to increase its profits from its various activities.

It's helpful to make the distinction between PPPs that develop and operate new assets—often known as greenfield projects—versus the PPPs that are formed to operate existing—or brownfield—assets. In the latter case, the private sector typically pays a lump sum or some percentage of future revenue to the government in exchange for the right to operate and maintain the existing facility, perhaps along with commitments for upgrades or expansion. This results in quite a different risk-sharing scenario than that of a PPP that actually builds a new asset.

Mexico has recently tried to combine these two formats in the case of several toll roads that the government had either acquired or built earlier. The government wanted to denationalize the roads by packaging them with development or expansion opportunities. Strong roads and relatively riskier assets were packaged together in the hopes that private investors would see the overall value and potential or a blended portfolio at a price that was favorable to the government.

Regardless of an occasional failure, PPPs have over and over again demonstrated their strength as a means to finance, construct and manage major infrastructure projects in a cost-effective and timely manner. They offer a key way to supplement traditional public works procurement, and to stretch limited public resources while reducing overall risk and cost. Negotiated and managed wisely, the arrangement can prove to be beneficial to both the government and private-sector investors, as well as the people who use the road, bridge, airport or other asset that results from the partnership.

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