

Dagmara Hajdys

Public-private partnership as a means of financing infrastructure projects of local governments under increasing debt

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DAGMARA HAJDYS

University of Łódź

**PUBLIC-PRIVATE PARTNERSHIP AS A MEANS OF FINANCING
INFRASTRUCTURE PROJECTS OF LOCAL GOVERNMENTS
UNDER INCREASING DEBT**

Introduction

The development and attractiveness of local government units (LGU) are determined by the range of services and infrastructure projects they can deliver. Operating in a complex legal and economic setting, local governments have to implement many measures to fulfil their public responsibilities mandated by the law and to further socio-economic development in their areas. Globalization, particularly the movement of human capital, not only increases and varies public demand for services delivered by local governments, but also reveals the discontent of infrastructure users with their range, quality and availability. When communities are becoming increasingly demanding, LGUs must undertake infrastructure projects to modernise the existing property and to create new assets.

Finding appropriate sources of finance is a key element inherent in every investment process. From the perspective of local governments, the question about how to finance public services and projects is particularly important. When budgets are tight and debts are rising, local governments are forced to develop and implement new financial instruments. One of the instruments that have been widely promoted in recent years is public-private partnership (PPP). The economic slowdown and financial problems burdening local governments

are the main factors explaining why PPPs are increasingly viewed as a means of carrying out infrastructure projects.

This article seeks to determine whether the amount of local government's debt and its readiness to engage in a PPP are related to each other. In fulfilling this aim, the article briefly describes the concept of public-private partnership and presents the EU and national laws applying to PPP agreements and their effect on public deficit and public debt.

This article has been based on a review of the relevant literature and laws, and on the analysis of financial data on LGUs with PPP agreements derived from a questionnaire survey.

1. The concept of public-private partnership

The delivery of infrastructure projects is one of the most important challenges faced by local authorities. When the demand for high quality projects is huge, the availability of finance is one of the major factors in whether a project will take off or not.

Partnership means an understanding between two or more parties that enter into cooperation to reach a common goal. Cooperation develops from compromise, openness to the needs of the other party, and negotiatory decision making¹.

The term 'public-private partnership' has roots in the very nature of partnership and is widely understood as a case where the public and private sector entities enter into cooperation to deliver public services more effectively. The various forms of this cooperation in countries that use public-private partnerships to provide infrastructure projects has caused that the documents of government and financial institutions have different names for them. In the literature too, public-private partnership has many definitions and names.

K. Brzozowska describes public-private partnership as "the cooperation between the public sector and the private sector, the aim of which is to carry out tasks traditionally performed by the public sector"².

¹ Z. Woźniak, *Między rywalizacją a partnerstwem. Bariery współpracy władz samorządowych z organizacjami pozarządowymi*, w: *Samoorganizacja społeczeństwa polskiego. Trzeci sektor*, red. P. Gliński, B. Lewenstein, A. Siciński, IFiS PAN, Warszawa 2002, s. 100.

² K. Brzozowska, *Partnerstwo publiczno-prywatne w Europie, cele, uwarunkowania, efekty*, Wydawnictwo Fachowe CeDeWu, Warszawa 2010, s. 30.

According to J. Zysnarski, public-private partnership stands for cooperation between public entities and private entities within the domain of public tasks³.

A. Cenker defines PPP as the cooperation between the public sector and the private sector in the delivery of public services, which allows each party to attain their goals, respectively the fulfilment of collective needs and satisfying rates of return⁴.

The World Bank interprets public-private partnership as a form of long-term cooperation where the private sector and the public sector come together to deliver services on a mutually profitable basis; the key characteristics of this cooperation is its focus on the accomplishment of public and business objectives⁵.

For the European Commission, public-private partnership is “a partnership between the public sector and the private sector for the purpose of delivering a project or a service traditionally provided by the public sector”. The partners profit from the cooperation proportionally to their engagement. The relations between them are based on the principle that risks are borne by those best able to control them⁶.

The term “public-private partnership” that appeared in Poland in the second half of the 1990s did not initially apply to any specific form of cooperation between public and private entities. Its detailed definition has only been provided in the public-private partnership act that describes it as cooperation between a public entity and a private partner in the joint delivery of a project, where responsibilities and risks are divided between the partners⁷.

The above definitions show the following, major characteristics of PPPs⁸:

- a) the long-term character of the agreement; as the private partner will provide public services long into the future the agreement must cover

³ J. Zysnarski, *Partnerstwo publiczno-prywatne w sferze usług komunalnych*, Ośrodek Doradztwa i Doskonalenia Kadr Sp. z o.o., Gdańsk 2007, s. 9.

⁴ A. Cenker, *Partnerstwo publiczno-prywatne*, INFOS, „Zagadnienia Społeczno-Gospodarcze” nr 13(37), Biuro Analiz Sejmowych, Warszawa 2008, s. 1.

⁵ Definicja partnerstwa publiczno-prywatnego zamieszczona na stronie internetowej Banku Światowego www.worldbank.com

⁶ *Guidelines for successful Public-Private Partnerships*, EC, Brussels 2003, p. 16.

⁷ Ustawa z dnia 19 grudnia 2008 r. o partnerstwie publiczno-prywatnym, DzU 2009, nr 19, poz. 100 z póź. zm., art. 1 ust. 2.

⁸ *Nowoczesne systemy realizacji zadań publicznych. Poradnik PPP*, red. M. Chałas, Dom Wydawniczy ELIPSA, Warszawa 2006, s. 18.

- an appropriately long period to allow public authorities to design structured and consistent policy for the development of local infrastructure and public services; the private partner must undertake a sequence of activities leading to the fulfilment of the whole agreement, rather than performing a single task; the public partner is responsible for specifying the project and for monitoring and controlling the performance);
- b) competitive proposals; the private partner is selected through a fair tendering process;
 - c) particular risks and responsibilities are assumed by the partner that can manage them best;
 - d) the management skills of the private partner are exploited to ensure that the purpose of the agreement is accomplished correctly and on schedule;
 - e) the partners work towards a common objective and profit from the cooperation; in that process, though, they are guided by their respective goals, i.e. the fulfilment of public needs (the public partner) and a satisfying rate of return (the private partner). Sub-goals are the stepping stones leading to the accomplishment of the principal purpose of the partnership;
 - f) value for money; the PPP benefits must be juxtaposed with those offered by a traditional public procurement process. An important element of the value-for-money indicator is project costs related to each of the two solutions;
 - g) partnership is based on market rules applying to the specific project. This approach emphasises the economic aspect of a project or the delivery of public services rather than political benefits, thus increasing the likelihood that goods and services will be provided effectively and at a lower cost.

Having chosen a PPP as the vehicle of a project, the public sector gains access to:

- a) private sector's financial resources that otherwise (public procurement) would not be accessible;
- b) modern, innovative solutions that private partners contribute to joint projects;
- c) the expertise and skills of the private partner.

Public-private partnership is a complex process making use of a whole range of organizational, legal and financial procedures in order to fulfil its purpose as determined by the role and function of the public partner.

2. The impacts of PPP agreements on the level of public deficit and public debt

The financial and economic crisis has slowed down the economy and has increased the debt of local governments. This makes them focus on the fulfilment of their current responsibilities rather than on investment activity. A remedy capable of reactivating them as investors is projects carried out through public-private partnerships and the capital contributed by private partners. A PPP project is a worthwhile solution from the perspective of an LGU, because in some legitimate cases the arising debt does not have to be added to public deficit and public debt. The main criterion for deciding whether, or not, liabilities should increase public debt and public deficit is the way project risks have been distributed between the partners. The effect of PPP agreements on public deficit and debt has been dealt with in the Community law. In Poland, this matter is regulated by the public finance act and the regulation issued by the Minister of Finance.

At the Community level, the key document on PPP agreements and their effect on public deficit and public debt is the Eurostat Decision no. 1804/18 of 11 Feb. 2004⁹. The document provides that for assets covered by long-term agreements concluded between public and non-public partners to be considered non-public there must exist strong evidence that the private partner carries most contractual risks. To prevent possible disputes over when and which risks make PPP agreements neutral to public deficit and public debt, Eurostat has formulated three main risks that, depending on their allocation, may have effect on public debt. These are the construction risk, availability risk and demand risk. To be neutral to public deficit and public debt, a PPP agreement must fulfil the following criteria:

1. the private partner carries the construction risk,
2. the private partner carries the availability risk or demand risk,

⁹ Decyzja Eurstat o traktowaniu partnerstwa publiczno-prywatnego i jego wpływie na dług i deficyt publiczny, Released 18/2004, 11 Feb. 2004.

3. no mechanisms exist that could be used to transfer the majority of risks to the public entity.

If any one of the criteria is not met, then the public entity must report the PPP liabilities on its balance sheet¹⁰.

Polish LGUs are not allowed to borrow more than the public finance act¹¹ allows them. The act provides for two types of control, which will remain in force to the end of 2013. The first of them requires that all debt to be repaid in the financial year (credit and loan payments, payments that may arise under the granted sureties, credit and loan interest falling due in the year; the redemption of securities inclusive of applicable interest and discounts, and amounts that may become due in relation to the granted sureties and guarantees) may not exceed 15% of LGU's revenues budgeted for that year. The other statutory cap prescribes that the total amount of LGU's debt at the end of the financial year may not exceed 60% of its actual revenues. The new solution to become effective on 1 January 2014 provides local governments with an algorithm (art. 243, item 1, par. 3 of the public finance act of 2009) with which they will be able to calculate how much they can borrow:

$$\left(\frac{R+O}{D}\right)_n \leq \frac{1}{3} * \left(\frac{Db_{n-1} + Sm_{n-1} - Wb_{n-1}}{D_{n-1}} + \frac{Db_{n-2} + Sm_{n-2} - Wb_{n-2}}{D_{n-2}} + \frac{Db_{n-3} + Sm_{n-3} - Wb_{n-3}}{D_{n-3}} \right),$$

where:

the symbols in the formula denote: R – the total debt that the LGU has budgeted for the given year, including loan and credit payments, the redemption of securities the LGU issued to cover its temporary budget deficit in the year, the projected deficit, the repayment of debt arising from earlier issued securities, credits and loans, contributions to projects co-funded by the EU, and expenditures on investment activity and capital investments; O – credit and loan interest, interest and discount on securities issued for purposes described under R, and payments resulting from granted pledges and guarantees that the LGU has budgeted for the given year;

¹⁰ *Metodologia tworzenia analiz ryzyka w projektach PPP i ich podziału pomiędzy stroną publiczną i prywatną w kontekście ich wpływu na klasyfikację projektu pod kątem długu i deficytu sektora publicznego*, red. Ernst & Young, Hogan Lovells, Ministerstwo Rozwoju Regionalnego, Warszawa 2012, s. 9.

¹¹ Ustawa o finansach publicznych z 27 sierpnia 2009 r., DzU 2009, nr 157, poz. 1240 z póź. zm., art. 243.

D – all budget revenues in the financial year; Db – current revenues; Sm – gains from the sale of property; Wb – current expenditures; n – the financial year for which the calculation is made; n-1 – the year before n; n-2 – the year two years before n; n-3 – the year three years before n.

The current public finance act does not specifically refer to liabilities arising under public-private partnerships, treating them as a sub-class of debt items. To make the provisions of the act more precise, the Minister of Finance issued a regulation on the specific classification of debt items falling under the category of government debt¹². Article 3, item 2, of the regulation provides that PPP liabilities should be reported as a public debt item under “credits and loans”, when they really affect its level.

A public-private partnership must be preceded by a thorough and reliable analysis of the related risks and those identified must be appropriately divided between the partners. A well-documented distribution of risks based on an in-depth analysis of the circumstances provides grounds for concluding whether a partnership agreement will, or will not, have effect on public deficit and public debt.

3. The level of LGU’s debt and its readiness to enter into a public-private partnership

Local governments must control and monitor their debts in order to know whether they can afford investment activity, including infrastructure projects. The level of debt must be estimated with respect to the number and structure of liabilities.

To determine whether the amount of LGU’s debt and its readiness to conclude a PPP agreement are correlated, a questionnaire survey of sixteen LGUs, fifteen gminas and one powiat, that signed PPPs agreements between 2009 and 2011 was conducted.

The debt levels in the selected LGUs were established using an average debt rate and an average debt service rate. The first rate shows a relation between the total debt of the LGU and its revenues at the end of the financial year.

¹² Rozporządzenie Ministra Finansów z dnia 28 grudnia 2011 r. w sprawie szczegółowego sposobu klasyfikacji tytułów dłużnych zaliczanych do państwowego długu publicznego, DzU 2011, nr 298, poz. 1767.

The debt service rate is calculated as a ratio between all debt payments to be made by the LGU in the financial year (credit and loan payments plus interest, payments that may be required because of the granted sureties including interest and discounts, securities to be redeemed) and its total debt at the end of the financial year.

As found by the survey, two municipalities, Kraków and Gostynin, are close to the debt limit of 60%. Both of them are in the process of developing measures that aim to reduce their debts to 50% by 2016 (restructuring bonds, distribution of debt among municipal companies). The debt rates calculated for the other local governments do not exceed 50%. Table 1 shows average debt rates and average debt service rates characterising the surveyed LGUs.

Table 1

Average debt rates and average debt service rates by LGU with a PPP agreement, years 2009–2011

LGUs with PPP agreements	Average debt rate (%)	Average debt service rate (%)
Gmina of Gliwice	8.0	6.9
Gmina of Gostynin	52.0	11.2
Gmina of Kiszkowo	9.0	2.7
Gmina of Kobylnica	51.0	8.5
Gmina of Kraków	58.0	13.0
Gmina of Krapkowice	38.0	8.2
Gmina of Łazy	48.0	7.8
Gmina of Piecki	48.0	7.3
Gmina of Radzionków	40.0	5.8
Gmina of Skąpe	15.0	4.0
Gmina of Smółdzino	29.0	3.5
Gmina of Solec-Zdrój	20.0	6.2
Gmina of Sucha Beskidzka	29.0	6.7
Gmina of Ustka	47.0	6.3
Gmina of Wrocław	40.0	8.6
Powiat of Żywiec	35.0	6.5

Source: developed by the author based on a questionnaire survey.

Apart from three LGUs, the total debt rates of other LGUs with PPP agreements do not show their financial situation to be dramatic. Most of them have the rates below 50%. The annual amounts spent on debt service are also below the statutory limit of 15%.

A more detailed analysis of the data on LGUs' budgets show, however, that both types of rates increased in 2011. The direct cause was the regulation of 23 December 2010 issued by the Minister of Finance¹³, which widened the range of loans and credits falling under the category of debt and thereby increased the ratio between total debt and total revenues.

A new debt ratio to be calculated individually by LGUs will come in force in 2014. Having learnt that after 2014 their debt service amounts will be determined by the performance of their budgets in the years 2011–2013, in 2011 local governments started to work on generating operating surplus (current incomes minus current expenditure). Lower debt limits will not only dramatically reduce their investment spending, but they will probably also reduce the funding that they need to fulfil their statutory responsibilities. These will be the consequences of the policy that the national government has been pursued towards LGUs in the recent years, which fails to adhere to the constitutional principle of financial resources being proportional to the mandated tasks. In the opinion of the Krakow municipality's treasurer, one of the main financial problems faced by local governments is the insufficient grant to local schools transferred by the national government. In Krakow alone, the municipality's subvention to schools increased over the last four years from 139 million to 643 million PLN¹⁴. This problem calls for systemic solutions and for the amendment of the Teacher's Charter that the local government officials view as inconsistent with the present circumstances¹⁵.

It is also important to note that local governments have made the required financial contributions to projects co-funded by the EU, mostly from borrowed funds. It seems unlikely that LGUs could continue their current investment activity considering the debt they have already accumulated. This means that they will have to look around for sources of finance that will not generate additional liabilities. The most appropriate of them seems to be public-private partnerships. For the time being, Krakow is the only municipality that seems to support the thesis that LGUs are more likely to use a PPP for carrying out their infrastructure projects when their debt approaches its upper limit.

¹³ Rozporządzenie Ministra Finansów z 23 grudnia 2010 r. w sprawie szczegółowego sposobu klasyfikacji tytułów dłużnych zaliczanych do państwowego długu publicznego, w tym do długu Skarbu Państwa, DzU 2010, nr 252, poz. 1692.

¹⁴ A. Gniatkowski, *Forum niepokoju i nadziei*, „Wspólnota” nr 41-42/2012, s. 18.

¹⁵ Wnioski z dyskusji w ramach Kongresu Samorządowego: *Gmina 2012*, Poznań 20–23 listopada 2012 r.

Conclusion

Polish and EU laws provide local governments with a range of options they can choose from to finance their projects. Some of the options are typical of the public sector, while others have been “borrowed” from the private sector. Therefore, local governments can be creative in developing financial instruments for their projects.

In the time of rising debts and the never-ending dilemma over which tasks and projects should be given priority, public-private partnership seems to be the only rational source of finance. Considering that the number of PPP agreements studied during this research was relatively small, it cannot be clearly stated whether LGU’s debt and its readiness to enter into a PPP are related to each other. With the exception of the Krakow municipality whose total debt rate approached the statutory cap, the other fifteen LGUs in the sample took efforts to deliver public tasks through private partners as proven by the public-private partnerships they already concluded, even though their debt levels were still safely below the cap. Additional sources of funding that come with PPPs allow local governments to fund other statutory responsibilities that otherwise could not be fulfilled.

**PARTNERSTWO PUBLICZNO-PRYWATNE W FINANSOWANIU
INWESTYCJI SAMORZĄDOWYCH W WARUNKACH ROSNĄCEGO
ZADŁUŻENIA**

Streszczenie

Artykuł zawiera rozważania na temat zależności pomiędzy poziomem zadłużenia jednostek samorządu terytorialnego a skłonnością do zawierania umów o partnerstwo publiczno-prywatne. Ograniczenia budżetowe z jednej strony oraz ustawowe limity zadłużeniowe powodują, że partnerstwo publiczno-prywatne w najbliższych latach może stać się pożądanym sposobem finansowania zadań publicznych przez jednostki samorządu terytorialnego.

Tłumaczenie Dagmara Hajdys