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ALLOCATION OF RISK IN PUBLIC-PRIVATE PARTNERSHIP PROJECTS UNDERTAKEN BY LOCAL GOVERNMENTS IN POLAND

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Introduction

Risk is a major issue in public-private partnerships (PPP), because its predictability, calculability and allocation determine whether or not a public entity and a private investor will cooperate. PPP projects have a special way of dealing with risk that makes them different from traditional public procurement. Organizations make investment decisions at a point of time and in operational circumstances they know, but then quite a long time is needed for the investment process to complete and for its outcomes to be seen, sometimes as long as a dozen years or so. Investments decisions are therefore preceded by forecasts trying to estimate the probability of occurrence of factors that can influence project implementation and operation. However, predictions are always accompanied by risk, regardless of earlier analyses.

In the PPP context, allocation of risk consists in a rational division of known risks between the parties to a contract. Particular risks should be managed by the party that is the most competent and has the necessary experience to cope with them.

The purpose of this article is to present main risks related to public-private partnerships and analyse their allocation in PPP projects that local governments in Poland initiated between 2009 and 2011. The analysis uses data obtained directly from local governments.

The notion of risk and types of risk related to PPP projects

Risk is a multifaceted and heterogeneous notion. As particular sciences interpret it differently, a single, universal definition of risk is difficult to provide.¹ Risk has to do with

¹ S. Nahotko: *Ryzyko ekonomiczne w działalności gospodarczej*. Zeszyt nr 201, OPO, Bydgoszcz 2001, pp. 37–38.

uncertainty, but the two notions, although closely interrelated, are not synonymous. The two categories are involved in chronologically successive phases of the same decision-making process. Risk arises from uncertainty. The greater the uncertainty, the higher the risk and vice versa. Risk increases also in proportion to the amount of capital committed to a project and its materialisation may cause the investor to have lower returns or none at all, if the project fails. Risk changes every time a new decision is made, as well as under the influence of external factors. Risk and uncertainty are inherent in economic processes and cannot be separated from them.²

Risk should be understood as the limited predictability of the outcomes of an action, a danger, a possibility that the purpose of an action will not be accomplished or that its intended effects will not be produced.³ Sometimes risk is defined as the odds of a specific decision not achieving its goal.⁴

Risk in a PPP project is viewed as the uncertainty as to whether the intended project results, such as delivery of services or revenue, will actually be achieved. Regardless of why a project is established, the party to carry the cost of materialised risk must be designated. This makes allocation of risk an essential element in the structuring of a public-private partnership.⁵ The analysis of risks related to PPP projects is all the more important that their distribution between the public partner and the private partner determines the shape of their future cooperation, as well as having effect on key factors contributing to the value of a PPP project.⁶

R.S. Lintz distinguishes four types of risk accompanying PPP projects⁷:

- commercial risk related to financial management; its source is delays, which increase spending over the allocated budget, operational expenses rising in excess of the budgeted amounts, fines, damages, etc.;
- market and operational risk arising from possible changes in energy or fuels prices, or from falling demand for services;
- political risk that has a strong effect on the shape and course of cooperation between parties, while being outside their control;
- financial risk due to interest rate or exchange rate variations.

² A. Czachorowska: *Ryzyko działalności inwestycyjnej przedsiębiorstw*, PWE, Warszawa 2006, pp. 55–59.

³ *Zarządzanie ryzykiem działalności organizacji*, ed. J. Monkiewicz, L. Gąsioriewicz, Wydawnictwo C.H. Beck, Warszawa 2010, p. 34.

⁴ A. Manikowski, Z. Tarapaty: *Metody oceny projektów gospodarczych*, Wyższa Szkoła Ekonomiczna, Warszawa 2001, p. 30.

⁵ E.R. Yescombe: *Partnerstwo publiczno-prywatne. Zasady wdrażania i finansowania*, Wolters Kluwer, Kraków 2008, p. 338.

⁶ *Metodologia tworzenia analiz ryzyk 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*, Ministerstwo Rozwoju Regionalnego, Warszawa 2012, p. 16.

⁷ R.S. Lintz: *An overview of Alternative institutional Arrangements for the Delivery of Urban Service: Public/Private Partnerships*, A paper for the Local Government Partnership Program, USAID/ Chemonics International, 1999, pp. 26–29.

The European Commission that strongly promotes cooperation between the public sector and the private sector has defined risk as any factor, event or influence that may threaten the positive outcome of a project as regards its duration, cost or quality.⁸ In its *Guidelines for successful public-private partnerships*, the EC enumerates ten major risks which may occur in the course of a project. These are:

- revenue risk,
- choice of private sector partner,
- construction risk,
- exchange risk,
- political risk,
- environmental/archaeological risk,
- latent defect risk,
- public acceptance risk,
- hidden protectionism,
- sustainability risk.

In its opinion on risks involved in public-private partnerships, Eurostat divided them into three broad categories:⁹

- construction risk,
- availability risk,
- demand risk.

The Eurostat position as to risk identification and allocation is particularly noteworthy because PPP contracts may have effect on the levels of public deficit and debt in the country. The current Eurostat methodology credits assets committed to and generated through PPP projects to the balance sheet of the private partner if it agrees to assume construction risk and either or both availability risk and demand risk, thus explicitly releasing the public sector entity from having to account for any of them in its balance sheet. This allows public authorities to keep public deficit and debt levels unchanged.

The PPP literature also provides various categories of risks. Following a review of PPP risks, K. Brzozowska divided them into three major groups:¹⁰

1. *Political risk* caused by instability in the country, e.g. a war, riots, expropriations, tax rate changes, or frequent legislative changes. These factors may seriously threaten project deadlines, increase its costs, or lead to project abortion in the worst-case scenario.

⁸ *Wytyczne dotyczące udanego Partnerstwa Publiczno-Prywatnego*, Komisja Europejska, Bruksela 2003.

⁹ *Decyzja Eurostat o traktowaniu partnerstwa publiczno-prywatnego i jego wpływie na dług i deficyt publiczny*. Released 18/2004, 11 Feb. 2004, www.europa.eu (8.02.2012).

¹⁰ K. Brzozowska: *Finansowanie inwestycji infrastrukturalnych przez kapitał prywatny na zasadach Project finance*, Wydawnictwa Fachowe CeDeWu, Warszawa 2005, pp. 88–99.

2. *Technical risk* present throughout project duration, both at the design stage and the construction stage, as well as after the project has been put into operation. This risk may arise from inappropriately selected team of project managers, project supervisors and/or the teams doing particular jobs. Factors increasing the probability of technical risk to occur include the application of inadequate technologies and technical solutions, as well as factors connected with the natural environment. Each of them may cause the project to slip behind the schedule and thereby may change its costs.
3. *Economic risk* expressing the probability that the operator of the completed project will have smaller revenue than projected because of lower demand for services, higher operational and financial costs due to unplanned borrowing, or variations in interest rates and exchange rates.

In the Polish law, PPP risks were regulated by the statutory rule on risks involved in projects carried out through public-private partnerships¹¹ that the Minister of Economy issued as an executive law to the public-private partnership act of 2005¹² (in 2009 the act was replaced by a new public-private partnership act passed in December 2008¹³).

As the present act leaves out the area of PPP risks, it has become the responsibility of the parties to a contract to identify and allocate them. The rule guiding this process is that risk should be managed by the more competent party.

Risk allocation in projects undertaken by local governments between 2009 and 2011

As local governments have limited budgets, they increasingly decide to seek private investors to finance their tasks. The developments that could be observed in the Polish market for PPP projects lead to two major conclusions. Firstly, the PPP act of 2005 did not perform as expected, because not a single project was implemented in Poland while it was in force. Secondly, with the new public-private partnership law being introduced in 2009 (i.e. the PPP act of 2008 and the act on concession for works or services of 2009¹⁴) procedures adapting the law to the practice could be initiated.

Legislative changes caused that advertisements inviting private partners to take part in joint projects started to be published in the Public Procurement Bulletin and the Official Journal of the European Union between 2009 and 2011. Most of them were placed by local governments that consequently signed a total of 20 contracts in that period.

Table 1 shows the numbers of concluded contracts by type of local government.

¹¹ Rozporządzenie Ministra Gospodarki z dnia 21 czerwca 2006 r. w sprawie ryzyk związanych z realizacją przedsięwzięć w ramach partnerstwa publiczno-prywatnego, DzU nr 125, poz. 868.

¹² Ustawa z dnia 28 lipca 2005 r. o partnerstwie publiczno-prywatnym, DzU nr 169, poz. 1420.

¹³ Ustawa z dnia 19 grudnia 2008 r. o partnerstwie publiczno-prywatnym, DzU nr 19, poz. 100, ze zm.

¹⁴ Ustawa z dnia 9 stycznia 2009 r. o koncesji na roboty budowlane lub usługi, DzU nr 19, poz. 101, ze zm.

Table 1

The numbers of contracts signed by type of local government from 2009 to 2011

Type of a local government	No. of PPP contracts		
	2009	2010	2011
Rural commune	2	2	1
Rural-urban commune	0	1	2
Urban commune	0	5	6
Powiat			1
Total	2	8	10

Source: developed by the author based on a questionnaire survey of local governments seeking private partners through the Public Procurement Bulletin and the Official Journal of the European Union.

The 20 PPP contracts were signed by 16 local governments. The leaders in that respect were the Małopolskie, Śląskie and Pomorskie voivodeships, which accounted for three contracts each. In the Dolnośląskie, Opolskie and Mazowieckie voivodeships there were 2 contracts per voivodeship. The last in the ranking were the Zachodniopomorskie, Lubuskie, Wielkopolskie, Warmińsko-Mazurskie and Świętokrzyskiego voivodeships where local governments signed single contracts.

The public authority and the prospective private partner had negotiated their contracts for many months before they were finally made. The main points in the negotiations were the division of tasks, the compensation for the private partner, public partner's contribution and its amount, but most of all the allocation of risks.

Because PPP projects may affect public sector's deficit and debt, the local governments under analysis made sure that risks were allocated in such a way that the contracts were neutral to the balances of their budgets. Table 2 presents the allocation of risks in the PPP contracts concluded.

Table 2

Risk allocation in PPP contracts signed by local governments between 2009 and 2011

Local government	Private sector partner	Type of local government's risk	Type of private partner's risk
1	2	3	4
Commune of Gostynin	Termy Gostynińskie Sp. z o.o.	– part of economic – legal	– part of economic – construction – demand – availability
Commune of Gliwice	Consortium: Kolejowe Przedsiębiorstwo Związkowe Sp. z o.o. IQ Sernice	– technical	– economic – demand – availability, – obtaining of necessary permits

1	2	3	4
Commune of Kiszkowo	Spółdzielnia Mieszkaniowa w Rybnie Wielkim	– part of economic – legal	– part of economic risk – demand – availability
Commune of Kobylnica	SON Sp. z o.o. based in Słupsk	– part of economic	– part of economic – construction – demand – availability
Commune of Kraków	Centrum Pogrzebowe Sp. z o.o.; Przedsiębiorstwo Usług Pogrzebowych „Klepsydra”; Urciuoli Group’s S.R.L. from Avellino (Italy)	– political – social	– economic – construction – demand – availability
Commune of Kraków	MPO Sp. z o.o.	– demand	– economic – availability
Commune of Kraków	Fortunet Robert Dulba (consortium leader), Atia Sp. z o.o.	– political	– economic – construction – demand – availability
Commune of Krapkowice	NZOZ „Vena” s-c Usługi Pielęgniarskie	– availability	– economic – demand
Commune of Krapkowice	„Świat do 3 lat” Usługi Opiekuńcze	– availability	– economic – demand
Commune of Łazy	PKM Sp. z o.o. in Olkusz	– demand	– economic – availability
Commune of Piecki	Vapo Sp. z o.o.	– political – social – demand	– economic – technical – availability
Commune of Radzionków	Simens Sp. z o.o.	– economic – political – obtaining of necessary permits	– economic – construction – availability
Commune of Skąpe	Handel – Tomasz Saszyński	– economic – political	– demand – availability – part of economic
Commune of Smołdzino	Zakład Usług Wodnych Sp. z o.o. in Słupsk	– political – demand	– economic – demand – availability
Commune of Solec-Zdrój	Malinowy Zdrój Sp. z o.o.	– part of economic	– demand – availability – part of economic
Commune of Sucha Beskidzka	Markam s.c.	– political – social	– economic – demand – availability
Commune of Ustka	Morpol SA Oddział Duninowo	– political – social	– economic – demand – availability
Commune of Ustka	Lazur Sp. z o.o.; Usługi Przewozowe <i>Ramzes</i>	– demand	– economic – availability

1	2	3	4
Commune of Wrocław	Mota-Engil Central Europe SA	– part of economic – political – social	– part of economic – demand – availability – construction
Powiat of Żywiec	InterHealth Kanada Ltd	– demand – availability – political	– economic – construction

Source: developed by the author based on a questionnaire survey of local governments seeking a private partner through the Public Procurement Bulletin and the Official Journal of the European Union.

The contractual provisions transferred most risks from local governments to their private partners. In 19 projects economic risk was entirely or partially the responsibility of the private investor, because local governments were intent on making the contracts financially neutral to their deficit and debt levels.

Construction risk involved in all construction projects was taken over by the private partner. Demand risk and availability risk were allocated to the public partner in four and three projects, respectively. In one project, the risk of obtaining necessary permits and approvals was managed by the public partner and in another by the private partner. In most contracts analysed, political and social risks were taken over by the public partner.

Conclusion

The pillar of cooperation between the public sector and the private sector is contracts prepared in such a way as to distribute the tasks and risks between the parties. As risks accompany all investment processes, their allocation is a linchpin of partnership contracts. It is in the interest of the parties that particular risks be transferred for management to the party that is most competent and capable of handling them. The possibility of dividing risks between the parties distinguishes PPP projects from traditional approaches to public procurement. Rational allocation of risks decides whether or not a project will be successful. Public partners are interested in moving as much risk as possible to the private partner to make PPP contracts neutral to their budgets.

PPP contracts concluded between 2009 and 2011 were negotiated by the parties for several months. As a result, the key element of partnership, i.e. risk, was allocated in most instances to the private partner. This allowed local governments to continue their development efforts without having to increase their liabilities.

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Summary

The article presents allocation of risks in public-private partnership projects undertaken by Polish local governments between 2009 and 2011. Risk is an extremely important issue because it is part of any activity, but particularly of investment projects. Allocation of risks in PPP projects is a key decision, as the accepted solutions determine the impact of a PPP contract on public deficit and debt levels. Based on her research, the author analyses the allocation of risks in PPP projects carried out by local governments.

**ALOKACJA RYZYKA W PROJEKTACH PARTNERSTWA PUBLICZNO-PRYWATNEGO
JEDNOSTEK SAMORZĄDU TERYTORIALNEGO W POLSCE****Streszczenie**

Opracowanie prezentuje zagadnienie alokacji ryzyka w projektach partnerstwa publiczno-prywatnego realizowanych przez jednostki samorządu terytorialnego w Polsce w latach 2009–2011. Problematyka ryzyka jest niezwykle istotna, gdyż w każdej działalności, a zwłaszcza inwestycyjnej występuje element ryzyka. W projektach PPP jest to kluczowe zagadnienie, gdyż jego alokacja przesadza o wpływie umowy o PPP na stan deficytu i długu publicznego. W oparciu o przeprowadzone przez Autora badania wskazano na podział ryzyk w realizowanych przez JST projektach PPP.

