SCIENTIFIC PAPERS
OF THE UNIVERSITY OF PARDUBICE
Series A
Faculty of Chemical Technology
15 (2009)

PROJECTS OF PUBLIC PRIVATE PARTNERSHIP AND ALTERNATIVE FORMS OF THEIR FUNDING

Veronika SABOLOVÁ
Department of Economy and Management of Chemical and Food Industry,
The University of Pardubice, CZ–532 10 Pardubice

Received September 30, 2009

The article deals with the issue of alternative sources of financing projects of Public Private Partnership. Each source of long-term funding is judged in light of usability for financing of the PPP projects. The sources, which are really usable and appropriate for funding of PPP projects, are depreciation, retained earnings, bank loans, financial leasing, corporate bonds, preferred and ordinary shares. Integrated view is provided in the form of table of all alternative sources of PPP projects financing.

Introduction

Public Private Partnership, usually abbreviated as PPP, is a general term for public-private partnerships, created for the purpose of the use of resources and capabilities of the private sector in the provision of public infrastructure or public services. If it is professionally and successfully applied, the PPP enables to enhance the quality and efficiency of public services (including the performance of government) and speeding up the implementation of major infrastructure projects with positive impact on the development of the economy.

The essence of successful PPP project is the assumption that can be achieved a greater contribution to public sector (in relation to the resources which the public sector would expend) by using the skills and experience of the private sector and the distribution of risks between the interested parties so that each party bears such a risk that can best be managed. PPP usually means shared participation of both sectors in the so-called "Special Purpose Vehicle" (SPV), which is a company that is specially created solely for the purpose of realization of the project — the company is governed by the Commercial Code [3].

PPP is a form of public-private partnerships in which the two sectors combine forces and resources for the purpose of realization of project on the basis of responsibilities and risks divided in advance so that both sectors can do what they can best. The aim of cooperation is to obtain higher value for money for the public sector and greater efficiency and the quality of public services.

The result of a well-prepared PPP project is a mutually satisfied long-term cooperation between the two sectors that is advantageous to both sectors. The private sector acquires the possibility of long-term income from interesting project, and the public sector acquires higher value for their money, higher quality for the same cost or the same quality at a lower cost. It is undesirable that the project should evolve in the imbalanced relationship where one party is gaining at the expense of the other. A key prerequisite for a successful PPP project is to qualified preparing and mutually beneficial flexible contractual relationship.

The decisive condition for a PPP project to be suitable is economical advantageousness for the public sector. The private sector must carry out the project at cost that is for public sector lower than the costs of the same project ensured by public sector itself from its resources. If this condition is unlikely to be met, then it does not make sense to carry out the project by the form of PPP [4].

The advantage of PPP lies in the fact that it offers governments and municipalities the option to bridge the gap between the need for investment funds and lack of finances in tense public budget, intended to ensure the infrastructure and services. International experience suggests that the quality of services provided under the PPP system is often higher than the quality of services that is achieved in the context of traditional acquisitions of services. The private sector is also usually much more successful than the public sector in detection and managing potential risks, because it is assumed that the private partner has some experience with similar projects and, thanks to it, he knows about potential risks. One of other options for the public sector to save even more in building large infrastructure projects is using of funds from European Union Structural Fund [2].

The disadvantage is that if the project should be prepared well, its preparation itself is very lengthy. Negative is also insufficient experience of both partners — especially the public sector enjoys an advantage in the contracting of such projects — which is reflected in the information asymmetry that functions in favour of private companies because they have a natural effort and potential to negotiate better terms for themselves. From the macroeconomic point of view, it may be considered that a significant disadvantage lies in the fact that, in consequence of the long duration of such projects, there is increase in mandatory spending and emergence of hidden debt that will be manifested for many years, and so can adversely affect the fighting power of future governments and significantly burden future generations [5].

Funding of PPP Projects

A PPP project is most often realized by establishing a special purpose vehicle. From an institutional point of view it means creating a new legal entity. This entity is most often in the form of a consortium of companies. But according to the Czech legal system, a consortium of companies has no legal personality and therefore no legal form of business. Members of the consortium are the representatives of public and private sector, but also the financing bank. Private partner mostly has primary responsibility for the method of financing. This entity may have different forms of business. But the most important form of private business in the Czech Republic is a form of Joint Stock Company. This form of business is the best also for private partner of PPP projects, because these are large investment projects extremely demanding financial resources. Joint Stock Companies in the Czech Republic have the widest sphere of action in the choice of sources of funding in the financial markets.

Joint Stock Company may use particularly long term resources for the financing of PPP projects. This limitation is due to the nature of PPP projects, which represent long-term connection for the purpose of investment project realization. In addition, long-term partnership implies the need for stable long-term resources, which would be risky to cover in short-term finances.

Long-term sources of financing are divided mostly according to the two fundamental aspects — according to their origin, and the ownership relationship. By the combination of these two breakdowns we gain matrix of long-term sources of financing investment projects, which is demonstrated in Table I. From this matrix of resources, the following items come into consideration for the financing of PPP projects — depreciation, retained earnings, share issue and alternatively also mezzanine capital — as representatives of own resources. Foreign resources are offered by implementation of bank loan, financial leasing and corporate bonds.

Table I The matrix of long-term sources of funding [1]

		Ownership of resourses	
		Equity	Foreign
Origin of resources	Internal	retained earnings depreciation profit funds	reserve
	External	basic capital (ordinary and preferred shares) capital funds mezzanine capital	bank loans corporate bonds supplier credits notes payable costumer advances financial leasing

Improper Resources for Funding of PPP Projects

In connection with the financing of PPP projects, the following items are not appropriate financial sources — profit funds, reserves, capital funds, supplier credits, notes payable and customer advances. The largest amount that is included in the category of profit funds has the form of a reserve fund from profit. The legal form of such a fund has a strict purpose use, designed only to cover any losses the company. Voluntary reserve fund or other funds from profit (investment fund, development fund) can be used as a source of project financing, but essentially they are the resources derived from retained earnings, accumulated for more accounting periods. A similar situation occurs in the funding through the reserve. The reserves have also legally clear purpose of creating and drawing, mainly due to the tax exercisability of reserve. Thus, neither reserve belongs to the financial portfolio of PPP projects.

The capital funds are the share premium account, gifts and grants. Share premium account is regarded as capital income rather than as a source of financing large projects. Together with the gifts they are, therefore, unacceptable for the financing of PPP projects. However, grants are acceptable and applied. Grants, as a contribution from public funds, are cut out in this analysis, because it is basically a returnable transfer of the responsibility for financing from the entity of private sector back to a public authority. But an important source of financing of investment projects — such as the PPP projects — appears to be grants from the European Union.

Supplier credit, notes payable, and customer advances fulfil an only marginal function and are practically unused sources of financing PPP projects. Supplier credit is caused by delaying payment for the supply for the predetermined period of time. An analogy is customer advance — advance is given for future delivery. The lack of suppliers and customers willing to provide their funds in the form of credit to their hamper usage of supplier credits and customer advances. Notes payable represent certificate of debt, negotiated individually between two subjects. Resources obtained by this form, therefore, probably do not cover extensive need of resources of PPP projects financing.

Proper Sources of PPP Projects Funding

In deciding which source to use for project funding, the company relies primarily on the aspect of cost (the costs of each type of capital). This decision is also affected by a general tendency not to spread influence over the control of the company. Based on these simplifying conditions of choice of funding sources, there was established a hierarchical procedure for order of resources. This is only a simplified view of the choice of specific sources of funding.

When choosing the order of resources, the subjects primarily consider use of their own internal resources in the form of depreciation and retained earnings. After exhausting these resources, foreign external sources, such as bank loans, financial leasing or corporate bonds are eligible. If neither of these resources is sufficient in volume, the subject's own external source in the form of share issue is chosen. At first the preferred shares and subsequently ordinary shares are chosen for such issue of shares.

The use of depreciation to finance projects of public private partnership is meaningful, because it is a significant internal source of financing business needs (it is indicated that depreciation represents 50 % of the volume of tangible and intangible corporate investment). Moreover, it is highly stable source of funding, because depreciation is not affected by many factors such as, e.g., profit (it may be used if incomes cover only the cost level and do not bring any additional earnings). Despite these facts, depreciation is a rather complementary source of finance for PPP projects (especially useful for the already well functioning stray projects), because particularly in the initial phase of the project a greater level of resources is needed. System of depreciation of enterprise assets has great importance, because it can greatly affect the possibility of realization of the PPP project itself (the method of depreciation has influence on the financial management of firm).

Application created and retained earnings: for the private partner of a public private partnership it is natural to use his own resources for the development and growth of his company. Use of the private partner earnings to finance the implementation of the project itself is a logical choice. However, as regards the financial intensity of PPP project, it can be judged that retained earnings will form only complementary component in the portfolio of financing project. In later stages of implementation, however, they may constitute a sufficient source of funding daily operation of the project.

Financing activities by the bank loan fall under the category of long-term debt, together with, for example, corporate bond financing. These long-term financial resources represent debit or also recoverable financing. Loans from banks and other financial institutions have increasingly been used mainly in European countries, while in the United States corporate bond emission is much more applied. In the Czech Republic, the use of bank loan for the implementation of investment projects belongs to the European tradition of recoverable financing. Application to project financing of public private partnership is, therefore, highly probable. The volume of funds obtained pursuant to a request for bank loan is sufficient for the PPP project even though it reaches lower values than, for example, the emission of corporate bonds or shares.

The use of financial leasing to finance projects of public private partnership is an interesting option to ensure the estate needed to implement the project. It is not, of course, a sufficient source of funding to cover any financial needs of the project. It represents only a complementary (additional) source. Its use may be directed to the field of construction machinery, needed to implement the infrastructure part of the project. Another use may be in the acquisition of land and property which may be subject of the PPP project. Last but not least — as regards the provision of public goods of manufacturing nature — it is also possible to buy manufacturing machinery and equipment through the form of financial leasing.

Use of corporate bonds in the portfolio of financial resources in public private partnership projects is absolutely normal abroad. In the Czech conditions, however, corporate bonds still are relatively unimportant due to our still little developed capital market. Nevertheless, corporate bonds can be regarded as completely adequate source of funding for PPP projects.

For the use of preferred shares for financing projects of public private partnership, it is necessary to carry out the issue on the side of the private partner. The consortium, which is in charge of managing the PPP project and which brings together all interested sides (entity of public administration and the private partner) has no legal personality and is not by itself able to obtain any own capital. Emission of preferred shares must be made by the private partner on his own account. Preferred shares can be regarded as adequate resource of funding of PPP projects, because the issue of shares (whether ordinary or preferred) brings the possibility of obtaining large amount of capital.

Use of ordinary shares to finance the implementation of projects of public private partnership is offered as the best option. Ordinary shares provide a large volume of capital, which is for the implementation of PPP project needed: in the order of hundreds of millions crowns. Private partner — in the role of the issuer of ordinary shares — may obtain by this a fully fledged resource for securing funds for implementation of PPP project.

Conclusion

This article specifies a number of individual resources for financing PPP (see Table II) on the basis of theoretical considerations and scale of financing methods. The table shows an outline the specific features, which are typical of certain resources within the application in the Czech Republic. It also includes statement whether it is a full or complementary source for the application to the PPP projects. Also outlined are the main advantages and disadvantages of applying of appropriate financing source — when using for the realization of the PPP project.

Table II List of alternative sources of PPP projects financing

Form of resource	Long-term resource	Application in the CZ	Application in PPP	Advantage	Disadvantage
Depreciation	equity, internal		complementary source	stability	using for restoring of property
Retained earnings	equity, internal		complementary source	without secondary responsibilities against the provider	instability
Bank loans	foreign, external	used more than corporate bonds	fully fledged source	individual conditions	limited volume of means
Financial leasing	foreign, external		complementary source	use of assets without ownership	high total price of assets
Corporate bonds	foreign, external	more used in other countries (US)	fully fledged source	large volume of means	high emission fixed costs
Preferred shares	equity, external	almost absent	fully fledged source	no extension of influence to corporate management	high emission costs
Ordinary shares	equity, external		fully fledged source	no fixed obligation to dividends	time and administrative intensity of emission

References

[1] Kislingerová E., Boukal P., Čepelka V., Hnilica J., Novotný J., Scholleová H., Sieber P., Vávrová H.: *Managerial Finance* (in Czech), 2nd edition, C.H. Beck, Prague, 2007.

[2] Ostřížek J., Krucký J., Přenosil J.: *Public private partnership: Opportunity and a Challenge* (in Czech), 1st edition, C.H. Beck, Prague, 2007.

[3] PPP Centrum: *Briefly about PPP* (in Czech) [online], [cit. 2009-10-01], available from URL: <http://www.pppcentrum.cz/index.php?cmd=page&lan

g=cs&id=122>.
[4] PPP Centrum: *More Information about PPP* (in Czech) [online], [cit. 2009-10-01], available from URL: <http://www.pppcentrum.cz/index.php?cmd=page&lang=cs&id=101>.
[5] Tetřevová L.: *Project Financing* (in Czech), 1st edition, Professional Publishing, Prague, 2006.