

Risk Allocation in Public-Private Partnership (PPP) Projects for Wastewater Treatment Plants

Samuel Capintero, Ole H. Petersen

Abstract—This paper examines the utilization of public-private partnerships for the building and operation of wastewater treatment plants. Our research focuses on risk allocation in this kind of projects. Our analysis builds on more than hundred wastewater treatment plants built and operated through PPP projects in Aragon (Spain). The paper illustrates the consequences of an inadequate management of construction risk and an unsuitable transfer of demand risk in wastewater treatment plants. It also shows that the involvement of many public bodies at local, regional and national level further increases the complexity of this kind of projects and make time delays more likely.

Keywords—Wastewater, treatment plants, PPP, construction.

I. INTRODUCTION

IN early 2004 the regional government of Aragon (Spain) faced the daunting challenge of building 131 wastewater treatment plants with a value of app. Euro 330 million. The reason behind this initiative was to comply with the European Union regulations that made it compulsory by December 2005 to treat wastewater in all municipalities that had over 2,000 equivalent inhabitants. The regional government decided to use the public-private partnership (PPP) formula because of the lack of financial resources to build the plants.

The 131 plants to be built were bundled in 13 concession contracts of around €20-30 million, each of them covering a specific area of the region. The concession tenders were grouped in three phases (rounds), as shown in Table I. In all cases, concession period was 21.5 years (1.5 years for the design and construction, and 20 years for the operation). As of mid-2014, 102 plants had been built and were in operation, and 14 more plants were under construction.

TABLE I
PHASES OF THE CONCESSION PROGRAM

Phase	# contracts	# plants	Inv. (€M)	Awarded
1	7	77	194	Dec. 2005
2	3	17	43	March 2007
3	3	37	93	Nov 2008
Total	13	131	330	

This paper examines to which extent the risk sharing has been efficient and how this has influenced the outcome of the projects. The examination of risk transfer in this case-study is carried out with reference to the following key PPP risk

categories: construction risk, revenue risk, operating risk and availability risk. These categories have been selected based on the classification of risks carried out by a number of studies [1]-[3]. We have focused on those risks that are more relevant for the purpose of this research.

The article's empirical base consists of data provided by official sources as well as information collected through face-to-face interviews with private representatives of the stakeholders participating in some selected projects. Interviewees include managers of the concessionaires, experts in wastewater treatment plants and representatives of banks involved as financiers in the projects. Unstructured in-depth interviews have been adopted as a means of investigation for this study because of its powers to achieve honest and robust responses and to ensure realism in the collection of an overall impression of stakeholders' perspectives.

II. LITERATURE BACKGROUND

This paper revolves around two main points that have been extensively analyzed in the literature on PPP projects. The first one is that PPP projects avoid cost and time overruns when compared to traditional public procurement. The second one is that this happens mostly because of an efficient risk allocation. In this section we review the literature about these two points and explain what adds this paper to the existing literature. We have not included in this section the literature review regarding these two issues. We have also reviewed the studies focused on the utilization of PPP arrangements to build and operate wastewater treatment plants. We found very few of these studies. Ali et al. [4] carries out a quantitative analysis on the valuation of minimum revenue guarantees in this kind of PPP projects. It shows that, when there is minimum income guarantees, developing the projects in various stages reduces the risk assumed by the public sector. Memon [5] discusses the use of PPPs for water supply and wastewater treatment in Japan and identifies several factors for the successful implementation of this kind of projects. The only case study we have found is [6], which examine the first PPP application for wastewater treatment in Taiwan. The study provides some lessons learned from this experience, mostly related to the procurement procedure. Some other projects have been reported, as explained in the introduction, but have not been analyzed in academic papers.

III. CONSTRUCTION RISK

The terms of reference of the tenders established that the concessionaires had 18 months for the elaboration of the construction designs and for building the plants. However,

Samuel Carpintero is with the Polytechnic University of Madrid, 28040 Ciudad Universitaria, Spain (phone: 34 913366649; fax: 343815947; e-mail: samuel.carpintero@upm.es).

Ole H. Petersen is with Roskilde University, Copenhagen, Denmark (e-mail: olehp@ruc.dk).

there were long delays in all projects, mostly because of problems with the availability of the lands, as well as with the authorizations for the construction and the entering in operation. In a few cases there were also problems related to the geotechnical risk.

A. Land Availability

Most of the projects experienced significant delays because of problems in having the lands available. These delays were in the range of 20-50% of the period established from contract signature until starting operation. The regional government was responsible for providing the lands to build both the plants and the main sewers. The terms of reference established that the lands should be available within four months from the contract signature—otherwise the concessionaire would be entitled to an extension of the concession period. Therefore, the delays in having the lands available were compensated by the regional government with extensions of the concession period.

The municipalities were in charge of making the arrangements to make the lands available for the concessionaires. The initial approach of the municipalities was not to expropriate but to negotiate with the owners of the lands (in order to reduce the political cost of taking the lands from their owners). However, this procedure proved very lengthy and, in many cases, fruitless. In the end, the officers of the regional government in charge of the program realized that it was necessary to expropriate. But the expropriation, according to the law, had to be done by the regional government (not the municipalities), and the expropriation procedure needed a long period to be carried out.

The officers of the program learnt from the experience of the early projects that they should start the expropriation procedure right after awarding the concessions. And this is what they did in the second and third phases of the program. Moreover, according to some stakeholders interviewed for this research, the experience of the projects of the first phase shows that the regional government, not the municipalities, should have been in charge of getting the lands available. And the expropriation procedure should have been used from the beginning. Furthermore, some stakeholders argue that the role of the municipalities should have been taken over but the regional government. The reason is that most of the municipalities are small (under 5,000 inhabitants) and the people in charge of dealing with these projects usually lack the preparation needed to deal with major infrastructure projects.

B. Permits and Authorizations

Another source of delays in the projects was the difficulty in getting the permits and authorizations for the construction and the entering in operation. Most of the projects had problems with getting the permits and authorizations, but the delays produced because of these problems were in most cases shorter than the delays produced because of the problems in getting the lands available. Therefore, the regional government did not need to provide extensions of the construction period for this reason.

The concessionaires were in charge of getting all permits and authorizations. It was necessary to ask for them to many different public bodies at local, regional and national level. And it took very long to get them. The lack of coordination among the many public bodies involved in providing the permits made this task even more difficult. The most problematic authorizations were the ones related to the electricity connection because it involves a particularly complex process.

Another authorization that took more time than anticipated was the one related to the supervision of the construction design. After being awarded the concessions, the concessionaires had two months to elaborate the construction design. It had to be submitted to the regional government, which had established a period of one month to approve it. But in most cases it took much longer. One of the reasons is that during the supervision of the design the regional government requested some changes because of technical reasons. Another reason is that the officers were overwhelmed with workload, especially in the first phase where seven contracts (totaling 77 plants) were launched at the same time. The public body in charge of supervising the projects and the construction process was reinforced with more staff but even though it was impossible to avoid some delays.

C. Geotechnical Risk

The concessionaire was supposed to assume geotechnical risk, although theoretically these risks should normally be allocated with the public partner rather than the private. In practice it was not so clear which part had to assume this risk. The bidders had a short period of time to prepare the bids (around two months). In addition, they had no access to the land at that time because they were not available yet. Therefore, they did not have the opportunity of carrying out tests to check the geotechnical conditions of the land.

In most cases, this did not represent any problem. However, in one of the projects of the first phase there were severe problems with the foundations and it was not clear who had to assume this risk. Since in this project there were problems also with the demand projections, this contract was terminated by mutual agreement and was expected to be put out for bidding in April 2014 (to be confirmed whether has been already awarded).

IV. REVENUE RISK

The revenue risk in these PPP schemes has two components: the demand risk and the formula to update annually the tariff to be paid to the concessionaire during the concession period. The regional government transferred demand risk to the private sector but this risk was mitigated through the payment mechanism. The retribution of the concessionaire is calculated according to:

$$Revenue = Q_A P_A + (Q_{measured} - Q_A) P_B$$

where $Q_{measured}$ is the real flow in each plant. The variables Q_A , P_A , P_B had to be submitted by the bidders for each plant in

their proposals. All these variables were capped in the terms of reference of the concession tenders with specific values for each plant. The maximum amounts allowed for these variables (Q_A , P_A , P_B) were established in such a way that the concessionaire had to get most of the revenue (roughly 95%) from the component $Q_A P_A$. The maximum amount allowed for Q_A was low and the maximum amount allowed for P_A was high. And the maximum amount allowed for P_B was low. In addition, the maximum amount of flow (Q_{measured}) that the generated revenue was capped at 1.1 Q_A (which means an increase of 10% over Q_A). This way, the concessionaire was quite sure that they were going to get 95% of the forecast revenue even with low flows.

The mitigation of demand risk has had two positive consequences: 1) There was a lot of competition for all projects (although it decreased in the consecutive phases of the program); 2) Only one contract has been renegotiated, and the reason was not a financial problem of the concessionaire. The size of the plant was dependent on the design flow (Q_D) that was estimated for each plant by the regional government. The regional government carried out thorough assessments of the demands estimated for each plant. They took into account the current population (both the usual one and in vacation periods), the existing industries, and the estimated growth of both population and industries.

The analysis of the revenue risk transferred in these PPP schemes has two components: 1) The flow Q_A and the tariff P_A ; 2) The formula to update annually the tariff to be paid to the concessionaire during the concession period.

A. The Flow $Q_A(m^3)$ and the Tariff $P_A(€/m^3)$

As already explained, the variables Q_A , P_A and P_B had to be submitted by the bidders for each plant. These variables had a great weight in the awarding criteria, as shown in Table II. All these variables were capped in the terms of reference of the concession tenders with specific values for each plant. The maximum amount allowed for Q_A was quite low compared to the maximum amount allowed for Q_D in order to make sure that the real flow was going to be above Q_A most of the time in all plants. In fact, Q_A is around 30%-50% of Q_D in most cases. As already explained, the concessionaire obtains roughly 95% of their revenue through the component $Q_A P_A$.

TABLE II
AWARDING CRITERIA

Criteria	Points
Economic criteria	
- Q_A, P_A, P_B	30
- The lowest investment cost	5
- Certificate of a bank securing financing of the project	5
Technical criteria	
- Related to construction	30
- Related to operation	30
<i>Total</i>	<i>100</i>

As of mid-2014, the real flow in roughly 95% of the plants was higher than Q_A but well below Q_D in almost all cases. This shows that the estimations of the regional government for

Q_A were accurate. But the assumptions for Q_D proved too optimistic. This led to build most of the plants bigger than what was really needed. It helps understand these wrong estimations that at the time of carrying out the demand studies (in the period 2005-2007) the construction of new houses was booming in Spain and the perspectives of population growth were very high. A few years later the perspectives are much gloomier because of the burst of the housing bubble and the global financial crisis.

B. The Formula to Update the Tariff to Be Paid to the Concessionaire

In the concessions of the first phase, the formula for the yearly update of the tariff P_A to be paid to the concessionaire was:

$$I = 0,75 + 0,25 \text{ CPI}_n / \text{CPI}_0$$

Therefore, only 25% of the revenues were indexed to inflation. This raised a lot of complaints by the concessionaires. They claim that the percentage of variables costs is much higher than 25%.

In the second and third phases of the program, this formula was changed to:

$$I = 0,58 + 0,42 \text{ CPI}_n / \text{CPI}_0$$

which means that the percentage of costs indexed to inflation increased from 25% to 42%.

The formula to index P_B to the inflation is different but its impact on the concessionaire's revenue is very low.

Therefore, the concessionaires assume the risk of potential increases of some costs that are not under their control but that have a great potential impact on their profits. In wastewater treatment plants, electricity cost has a great influence because it represents roughly 30%-40% of the total operating cost. In Spain, electricity cost has escalated in the past few years—it has increased by 65% in from 2006 to 2013 because of the liberalization of the electricity market (INE, 2014). However, the formula established in the terms of reference for the yearly update of the tariffs to be paid to the concessionaires does not reflect it. The concessionaires claim that the sharp increase of electricity costs is an unforeseeable risk and its consequences have to be assumed by the public sector. However, the public sector argues that the terms of reference of the concession tenders established that this risk was assumed by the private sector.

V. OPERATING AND AVAILABILITY RISK

The regional government has transferred this risk to the concessionaire through two ways:

- 1) If the plant interrupts its functioning the concessionaire is penalized.
- 2) The public body in charge of supervising the operation of the plants controls every week the quality of the water that comes out of the plant. If it does not meet the standards set in the terms of reference of the concession

tender, the concessionaire is penalized.

VI. DISCUSSION OF SOME RELEVANT ISSUES

The PPP program implemented by the regional government of Aragon to build and operate wastewater treatment plants basically followed the standard procedure that has been common in Spain for toll roads, field in which this country has an extensive experience. This helps explain how the government managed construction risk and allocated demand risk. According to the representatives of the public sector interviewed for this research, an additional reason for transferring demand risk to the private sector was to make sure that the PPP program abided by the EU regulations in order to be considered an off-balance operation for the public sector.

According to the interviews conducted for this research, the rush in implementing the program led to establishing excessively short periods of time for some tasks, like getting the lands available (four months), elaboration of the construction designs by the concessionaires (two months), and the supervision of each construction design by the regional government (1 month). The regional government wanted to build many plants in little time. On the one hand, they wanted to comply with the European Union regulation that made it compulsory by December 2005 to treat wastewater in all municipalities that had over 2,000 equivalent inhabitants. On the other hand, for political reasons—it was a way of getting votes in the following regional and local elections.

The private sector showed a lot of interest in participating in the PPP program and the competition for the projects was high. The number of bidders for each contract was between 13 and 18 in the first phase, between 16 and 19 in the second phase, and between 10 and 13 in the third phase. Most consortiums included companies with extensive experience in wastewater treatment, many of them big companies operating at national and international level. Some consortiums also included small local companies.

Arguably, the private companies were willing to assume demand risk and to make aggressive bids for various reasons. First, in the period 2005-2007 it was still easy to get financing for the projects, in most cases with low interest rates. Second, among Spanish companies of construction and utilities sectors, there is a long tradition of submitting aggressive bids in order to win the contract with the expectation of future renegotiations. Third, in those years there was a feeling of general enthusiasm in Spain because of the booming economic situation and all companies were willing to compete in order to expand their business.

In most cases, it was relatively easy to get financing for the projects. All projects were financed through project finance although the banks asked for recourse to the sponsors until the plants were in operation and had all authorizations. Most of the projects were financed before the global financial crisis. Therefore, most of the concessionaires got the financing in a period of time usual for project finance (10-12 months). Debt was around 75% of the initial investment in most cases and the spread over Euribor was around 100 basis points. However, in some cases, this spread increased sharply up to 300 basis

points because of delays in payments to the banks (it was so established in the clauses of the financing). Two of the three contracts of the third phase have not been able to get external financing (debt). One of them has been financed entirely with resources provided by the sponsors in the form of equity and the other one was cancelled. The three contracts of the third phase were awarded in November 2008 when the global financial crisis had already started.

VII. CONCLUSIONS

It is commonly asserted in international PPP literature that organization of construction projects through the PPP model improves on time delivery compared with traditional procured projects, which have a bad track record [7], [8]. Our analysis shows, however, that in this case substantial time delays were also experienced even though the PPP route was chosen. The paper argues that the main reason was an inadequate risk allocation model. Furthermore, we also show that this sub-optimal distribution of risks has resulted in a poor financial performance of the concessionaires which has seriously hampered the future involvement of the private sector in this kind of PPPs in Spain. An additional result from our analysis is that the involvement of many public bodies at local, regional and national level further increases the complexity of PPP projects and make time delays more likely. These findings provide useful lessons regarding the future utilization of PPPs for building and operating wastewater treatment plants and other infrastructure.

ACKNOWLEDGMENT

The authors gratefully acknowledge the support of ‘Cátedra Juan-Miguel Villar Mir in Business Administration’ of the Polytechnic University of Madrid, which provided funding for this research. They also wish to express their gratitude to the officials of the regional government of Aragon and the managers of the projects, who reserved time for interviews and supplied data for the study.

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