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STATSREVISORERNE



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The Ministry of Transport and the regions' decision- making on establishing public-private partnerships (PPP)

1. Introduction and conclusion

1.1. Purpose and conclusion

1. This report looks at the government's and the regions' decision-making on establishing a number of public and private partnerships (PPP) in the period from 2005 to 2020. The report also looks at the extent to which the basis for decision included documentation of the economic advantages offered by the PPP project structure to the government and the regions.

2. In 2003, the then Danish Ministry of Economic and Business Affairs issued executive order no. 1135 of 15 December 2003, which introduced the PPP project structure. With the Danish parliament's passing of law amendment no. 413 of 1 June 2005, it was decided that it should be possible to set up public construction projects as PPPs. The purpose of the law amendment was to increase both the efficiency and the effectiveness of the Danish construction sector, following analyses that had found that the efficiency of the Danish construction sector was not keeping up with the development in other lines of business neither domestically nor abroad. According to the bill, the government should consider the pros and cons of the PPP project structure in large construction projects as opposed to publicly financed turnkey projects.

3. PPPs involving private funding are a collaboration between a government agency and a private-sector company that generally entail financial leasing. Construction, running and maintenance are typically covered in one contract in PPPs. PPP contracts are entered between a public-sector entity and a private supplier. The private supplier is contractually bound to deliver and finance the construction project and subsequently ensure running and maintenance of the facilities for the term of the contract. The public entity that has commissioned the project pays the private partner for the use of the facilities through the life of the contract. PPP contracts generally run for 20 to 30 years. When the contract expires, the public authority will typically acquire the facilities at a previously agreed price.

4. There are two reasons why the financing costs of PPPs involving private funding are higher than the financing costs of projects that are fully financed by the government or regions: (1) private partners need a return on their investment over the 20 to 30-year concession period in which they manage the facilities, and (2) the government and regions have access to lower cost of financing. The government and the regions are required to take due financial considerations into account when spending public money, i.e. they are required to choose solutions that offer good value for money. It is therefore essential that the government and the regions' decision to choose a PPP project structure is supported by documentation of the financial benefits offered by the PPP project structure that outweigh the increased funding costs.

The study looks at 21 PPPs with private funding (municipal projects are not included). According to in-year budget adjustments and regional estimates, the total contractual value of the projects is approx. DKK 11 billion distributed on 11 government projects and 10 regional projects. Projects range from parking facilities over office buildings to psychiatric hospitals and a hospice. The most recent application for an in-year budget adjustment was approved by the Danish Finance Committee on 25 April 2019 and concerned the Court of Appeal of Eastern Denmark. This project is included in the study. The study does not include projects that had been tendered at the time of the study, but not yet contractually agreed. Among these are two PPPs tendered in 2020 and 2021 concerning regional psychiatric hospitals, each involving estimated construction costs of approx. DKK 500 million.

5. The purpose of the study is to assess whether the Ministry of Transport and the regions' have made their decisions to select the PPP project structure on an adequate basis. The report answers the following questions:

- Has the Ministry of Transport's decisions to select the PPP project structure been made on an adequate basis?
- Have the regions' decisions to select the PPP project structure been made on an adequate basis?

6. Rigsrevisionen initiated the study in November 2020.



Main conclusion

In the period from 2005 to 2020, the Ministry of Transport and the regions' have not had an adequate basis for selecting the PPP project structure. This entails a risk that the ministry and the regions have failed to take due financial considerations into account in their decision-making process.

The Ministry of Transport has not had an adequate basis for decision, when the Danish Building and Property Agency has selected the PPP project structure

Rigsrevisionen has established that the government's increased funding costs are reflected in the 11 PPP projects, but they are not specified in the basis for decision (the total cost of ownership (TCO) estimates). This results in a lack of transparency concerning the additional funding costs that the benefits of the PPP project structure are meant to outweigh. Rigsrevisionen has estimated that subject to certain conditions, the increase in funding costs associated with PPP projects equals the total construction costs. It is Rigsrevisionen's assessment that the Danish Building and Property Agency in the 11 projects reviewed by Rigsrevisionen, has failed to provide documentation of the benefits of the PPP project structure that are meant to outweigh the increased funding costs.

The selection of project structure is to a great extent based on estimated factors that cannot be validated. Pricing of the most significant variables (risk allocation factor, optimisation-equalisation-factor, minimum ROI requirement, construction costs and discount rate of interest) changes from project to project and are based on the Danish Building and Property Agency's professional, yet undocumented estimates. The review also showed that the qualitative assessments included in the basis for decision are undocumented and cannot be validated.

The Danish Building and Property Agency has, on several occasions, questioned the method applied, and the agency agrees with Rigsrevisionen that the TCO estimates are affected by uncertainty. Moreover, in 2017, the agency concluded that the method applied entailed a risk that the PPP project structure was being favoured by a bias of up to 20% compared to turnkey. The Danish Building and Property Agency has recommended the PPP project structure for five of the 11 projects, despite the fact that the agency's own financial estimates showed this was the most expensive solution.

The four regions that have selected the PPP project structure have not had an adequate basis for their decision

In 10 projects, these four regions have failed to provide any documentation that confirms the financial benefits of the PPP project structure. Two of the regions further failed to investigate whether other project structures would be more economically advantageous than the PPP project structure, before they entered into a contract. Two other regions investigated this issue, but failed to document that other (financial) benefits would outweigh the increased funding costs. Only the Capital Region of Copenhagen has not launched any PPPs, either because it considered the PPP project structure to be too expensive, or because it, for other reasons, did not consider the PP project structure appropriate.

Total Cost of Ownership - TCO

This is a calculation method that determines the overall cost of a product or service throughout its life cycle.

"Subject to certain conditions"

This wording refers to the conditions that were applied to the PPP project at the Danish National Archives in Viborg. Funding costs vary from project to project.

Turnkey

The PPP project structure is often assessed in comparison with traditional turnkey projects. Turnkey refers to construction projects for which the developer undertakes the whole responsibility from design to completion so that the building is available to the buyer in a ready-to-use condition.

The four regions with PPP projects have informed Rigsrevisionen that they consider the agreed projects to be economically advantageous, despite the fact that the PPP project structure seen in isolation is more expensive than alternative project structures. According to the regions, the reason is that breakeven will be achieved within a few years due to the efficiency gains resulting from the implementation of the more expensive PPP project structure.

Deposit exemption

Generally, the regions are not allowed to loan finance expenditure, unless they deposit an amount equivalent to the loan sum.

In recent years, the annual finance agreements between the government and the interest organisation of the Danish Regions have included special arrangements that exempts the regions from the deposit requirement in connection with PPP projects.

The study found that other considerations decide the outcome of deliberations on the selection of the PPP project structure. Among these, the possibility of deposit exemption and the fact that the capital investment ceiling does not apply to PPP projects. The two regions that have worked out TCO estimates selected the PPP project structure in spite of the fact that their own TCO estimates showed that they were the most expensive solutions.

The Danish Ministry of Interior and Housing and the Danish Ministry of Finance have informed Rigsrevisionen that the results of this study could provide the basis for a debate with the regions in connection with the discussions on a potential deposit exemption pool for PPPs in the future.

The Ministry of Transport has informed Rigsrevisionen that the criticism raised in this report has led the ministry to take steps to analyze on which basis decisions on selection of the PPP project structure should be made in the future. Possibly without including TCO estimates in the process. Rigsrevisionen finds that the Ministry of Transport should coordinate its initiatives with the Ministry of Finance, which has responsibility for the overall regulations and framework set for the application of the PPP project structure.