

**PUBLIC PRIVATE PARTNERSHIP IN NEW ZEALAND AND MALAYSIA**

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## Abstract

The importance of high quality infrastructure and its maintenance lies in its ability to stimulate economic growth as it fuels business activities, creates job opportunities, markets product, and generates earnings (Yakcop, 2006a). In consideration of this importance, the public sector encourages private sector participation in the delivery of public services and infrastructure in terms of funding and expertise. A successful Public Private Partnership<sup>1</sup> (PPP) is one vehicle used internationally. Both New Zealand and Malaysia acknowledge the potential of PPPs in delivering high quality infrastructure and services to the general public. Consequently, both countries made a move towards PPPs by creating PPP-specialized units and producing PPP guidelines. However, thus far, Malaysia has been more active in pursuing PPPs when compared to New Zealand's cautious approach to PPPs. Hence, the purpose of this thesis is to find out the reasoning behind this trend. Issues relevant to reasons for implementing PPPs, features of PPPs, allocation of risks, performance indicators and accounting for PPPs are analysed to justify this trend. This thesis finds that the Malaysian "Vision 2020" has signalled a government preference for PPPs, including its ability to encourage *bumiputera*<sup>2</sup> participation. Further, the government has developed a system involving Special Purpose Vehicles and utilizing government-held superannuation funds for project finance aid. Consequently, the system reduces the transfer of risk from the public sector to the private sector partners. This has transcended the major issue in New Zealand where the lack of a competitive market has restricted the development of PPPs. A lack of public support has also contributed to New Zealand's PPP under-development.

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<sup>1</sup> Known as Kerjasama Awam Swasta in Malay language

<sup>2</sup> The word *bumiputera* refers to the indigenous people of Malaysia

### **Dedication**

To those who have been supporting me unconditionally, without whom, this thesis would be incomplete; my family and friends.

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## 1. Introduction to PPPs

Country leaders noted the need for high quality infrastructure to reduce potential damage, to minimize loss of lives, and to support the survivors in the events of natural disasters such as earthquakes, tsunami, flood and landslide. The importance of high quality infrastructure and its maintenance lies in its ability to stimulate economic growth as it fuels business activities, creates job opportunities, markets product, and generates earnings (Yakcop, 2006a). In consideration of this importance, the public sector encourages private sector participation in the delivery of public services and infrastructure in terms of funding and expertise. A successful Public Private Partnership<sup>3</sup> (PPP) encourages this. A PPP, for the purpose of this paper, refers to a concession agreement involving (NIU<sup>4</sup>, 2009, p. 1; 3PU<sup>5</sup>, 2009, p. 4):

1. a long term partnership between a public sector partner (procurer) and a private sector partner (provider/operator);
2. delivery of public services;
3. construction of an asset or enhancement of an existing asset;
4. where the private sector partner finances, builds, operates, and maintains the asset (transfer of risks from public sector to private sector);
5. and the public sector partner compensates private sector partner for the public services (or payments may flow directly from public users); and
6. optional transfer of the asset to the public sector at the end of the contract.

The details of the partnership arrangements are contractually dependent, but a PPP cannot transfer the ultimate accountability for public service provision from the government to the private sector. In 2009, New Zealand and Malaysia published PPP guidelines respectively entitled *Guidance for Public Private Partnerships (PPPs) in New Zealand* and *Public Private Partnership (PPP) Guideline* (also known as *Garis Panduan Kerjasama Awam Swasta*) which provide PPP comprehension for the interested parties. Both guidelines are intended for long term contracts between the government and its private sector partners, in which the private sector will finance, construct, operate and/or enhance existing facilities or assets. Their ownership may revert to the government at the end of the contract if the asset is not obsolete. In return, the private sector partners will be compensated based on their performances as contractually agreed. It is noted that both guidelines are prepared in

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<sup>3</sup> Known as Kerjasama Awam Swasta in Malay language

<sup>4</sup> National Infrastructure Unit

<sup>5</sup> Public Private Partnership Unit



realization that the notion of PPP is not exhaustive. Hence, these guidelines are subjected to on-going revisions.

A PPP is distinct from its alternatives such as outsourcing, contracting out, New Public Management, and privatization, partly because it requires both public and private sectors to join forces for the benefit of the general public. Malaysia's Public Private Partnership Unit (3PU) (2009, p. 6-7) presented these differences:

**Figure 1 Differentiating conventional procurement, a PPP and privatization**

| <b><u>Conventional</u></b>   | <b><u>PPP</u></b>  | <b><u>Privatization</u></b>  |
|--|--|--|
| Funding via direct public budget   | Funding via private financial resources without public sector's explicit guarantee | Funding via private financial resources without implicit or explicit public sector guarantee |
| Immediate impact on public sector financial position   | Impact on public budget spreads over the duration of the concession                | No impact on the level of public sector expenditure  |
| Risks are entirely borne by public sector  | Risks are allocated to parties which can manage them most efficiently              | Risks are entirely borne by the private sector   |
| Extensive public sector involvement at all stages of project life  | Public sector's involvement is through enforcement of pre-agreed KPIs              | Government acts as regulator   |
| Short term relationship with private contractors   | Long term relationship with private contractors                                    | Long term relationship with private contractors  |
| Applicable for projects with high socio-economic returns and those justified on strategic considerations | Applicable for projects with commercial viability                                  | Applicable for projects with high commercial viability                                       |

As a PPP is output driven, it also motivates the private sector partner to innovate in delivering services and maintaining the assets. Takim, Abdul-Rahman, Ismail and Egbu (2008, p. 80) conducted research on the differences between a Private Finance Initiative (a subset of PPP, henceforth PFI) and a traditional procurement. They (Takim et al, 2008, p. 80) noted that a PFI differs from traditional procurement as it should: improve asset

maintenance; benefit local economic development; facilitate innovation; reduce public sector administration cost; enhance government capacity; and solve the problem of public sector budget restraint. Most importantly, PFIs (and PPPs) are advocated to enable the transfer of risks from the public procurer to the private sector provider.

Ismail and Yusof (2009b, p. 79 & p. 83) also noted that privatization focuses on selected economic infrastructure, particularly utilities, transport sectors and selected services of local governments whereas PFIs serve the wider economic sectors of utility, transport, education, health, office accommodation, housing, defence equipment and other types of public buildings and infrastructures. This difference may be due to the need for effective government monitoring and supervision that are required in a PPP to ensure conformance to government's standards, as against selective privatization which requires limited supervision.

From Figure 1 it can be seen that public expenditure level, risks, public sector involvement, duration of relationship with the private contractors, and project practicability differentiate a conventional procurement, a PPP and privatization. These differences have led to varying results, both favourable and unfavourable depending on the project's management and other external factors. Conventional procurement has been blamed for inferior works requiring high maintenance costs. Conversely, privatization has been associated with the delivery of high quality infrastructure, but at higher costs. Being in the middle of the contrasting conventional procurement and privatization, a PPP has been perceived as a combination of both which enhances the pros and minimizes the cons of the two ends (The Canadian Council for Public-Private Partnership, 2005).

A PPP can take on many forms as it is modifiable to meet country specific needs. These variations include (Network Strategies, 2008, p. 29):

1. traditional design and construction, whereby the public sector commissions the private sector to build the facility under a contract, typically for a fixed price;
2. operation and maintenance contract, where the private sector operates a publicly owned facility under contract to the public sector;
3. lease – develop – operate (LDO), where the private sector is awarded a long-term lease to operate and possibly to expand a facility;
4. build – own – maintain (BOM), where the private sector constructs, owns and maintains the facility, while the public sector leases and operates the facility;

5. build – own – operate – transfer (BOOT), where the private sector finances, constructs, owns and operates the facility for a specified timeframe after which ownership reverts to the public sector; or
6. build – own – operate (BOO), similar to the BOOT model but the private sector owns the facility in perpetuity.

While the guidelines for New Zealand and Malaysia are in place, the role of PPPs continues to evolve. Further, internationally, PPPs do not always meet the expectations. This thesis seeks to identify the cause(s) of Malaysia having more PPPs than New Zealand, despite the necessity for both governments to provide for high quality infrastructure. For this reason, this thesis will analyse the reasons for PPPs, the key elements of PPPs and to highlight the differences that exist in the New Zealand and Malaysian contexts.

The drive to opt for PPPs may be partly explained by the rational choice theory which will be applied in understanding the existence of PPPs. The next chapter will look at reasons for choosing PPPs, including the origins of PPPs in both countries. Continuing on, the success factors of PPPs which including features and risk allocation will be presented. Then, performance indicators will be discussed, followed by accounting issues of PPPs in the two countries. Subsequently, the challenges and issues that emerge with a PPP implementation will be discussed. The conclusion includes the limitations and further opportunities for research in this area.

## 2. Reasons for PPPs

Rational choice theory could justify the preference for PPPs to an extent. This theory is based on optimizing decisions and actions. It requires assessing the costs and benefits of each alternative to maximize utility or minimize disutility. Rationality results from the choice of action that corresponds with the optimal choice (Moll & Hoque, 2006, p. 8). A number of researchers have deemed PPPs as the optimal choice partly due to reports that well-managed PPP projects could overcome the problems associated with other procurement methods as seen in the United Kingdom and Australia. For an example, in the United Kingdom, PFIs *combine the best of public and private provision rather than regarding the two as mutually exclusive* (Broadbent & Laughlin, 2005, p. 58). However, in choosing a PPP project, the search for suitable partners and decisions about PPP elements such as allocation of risks, and thorough examinations of available options must be done scrupulously to ensure that the end result is optimal and utility-maximizing or disutility-minimizing. Hence, it appears that PPPs can theoretically provide rationality amid the identified constraints and resources.

In practice, Ng and Loosemore (2007, p. 68) believe that the appeal of PPPs lies in the shift of funding responsibility to the private sector which simultaneously reduces public debt, reduces finance costs, and most importantly allows investment in other areas of public interest such as education and welfare. They (2007, p. 68) added that with PPPs, the public sector could reduce its in-house project management, maintenance workforce, and equipment needs which consequently releases additional funds for other public services investments. Attractively, projects that would have been delayed or halted with conventional procurement could be resumed and potentially delivered earlier because of the finance capacity of the entire private sector (Ng & Loosemore, 2007, p. 68). Ostensibly, these claims suggest that PPPs could practically provide additional benefits to government (and society) that other procurement methods may not be able to provide. In light of rational choice theory, choosing PPPs appears to be an appropriate reaction to existing procurement problems.

## 2.1. Origin of PPPs

Historically, the emergence of a PPP was related to the concerns around increasing public debt levels. In order to deliver public services, the government had to find other ways to fund infrastructure. Hence private sector participation in public service delivery emerged as a viable alternative to combat increasing debt. Since then, Hammami, Ruhashyankiko and Yehoue (2006) hypothesized that PPP determinants could be influenced by government constraints, the political environment, market conditions and macroeconomic policies, institutional quality and a country's legal system, government's past experiences with PPPs, and private participation in PPPs. These hypothesized determinants represent the likelihood of PPPs' presence in a given environment. Higher government constraints, a stable political environment, viable market conditions and macroeconomic policies, a strong institutional quality and legal system that protects investor's rights, experiences with past PPPs and the acceptable extent of private participation in PPPs could positively affect government, leading to the choice to undertake more PPPs.

Hammami, et al. (2006) found that there are more PPP projects in an environment with large markets and high demand for infrastructure, governments burdened by high debts, macroeconomic stability (i.e. stable inflation), low corruption, strong rule of law, stable institutional and legal frameworks, and edifying past experiences with PPPs. They additionally found that political stability does not statistically influence the number of PPPs. However, the high use of PPPs in the United Kingdom and Australia suggest that there will be more PPPs in a country where the countries are politically stable, owing to the low PPP resistance that allows for political commitment to PPPs (Hallyar & Wettenhall, 2010, p. S4). This greater take up is because a PPP involves a long term commitment that will legally bind the government to the private sector and a stable government will provide comfort to the private sector. Governments' reputations are also a factor. A transparent and honest government is desired by the private sector partners so that their participation will not be stained by corruption. Similarly, governments need to engage reputable and trustworthy partners for PPPs.

PPPs are also more likely to develop in a country that politically accepts them. As for the level of investment, it is basically influenced by funding availability which can be somewhat politically influenced. Hammami, et al.'s (2006) research also shows that market conditions appear to be the most common determinant in the energy, telecommunication,

transportation and water sectors. The outcome of their research suggests that PPPs emerge as a rational choice after evaluating the environment that warrants the need for a PPP.

### 2.1.1. Origin of PPPs - New Zealand

New Zealand has many of the factors that Hammami et al. (2006) suggested were necessary to give rise to the emergence of PPPs. High government debt is a current issue, also there is political and economic stability, low corruption, a stable institutional and legal framework, well-functioning market and a high demand for infrastructure. However, the Chief Executive of the New Zealand Council for Infrastructure Development, Stephen Selwood, admitted that New Zealand was lagging in terms of improved infrastructure development despite the potential of PPPs. The Press (Partnership report card varied, 2007, p. 15) quoted him saying that “PPP’s are being used extensively worldwide to bridge the gap between infrastructure demand and the limitations of public funds.” The New Zealand Land Transport Management Act (NZLTMA) 2003 empowers public road controlling authorities to enter into concession agreements between a third party and a public road controlling authority relating to the construction or operation of a roading activity. Yet it appears there is still some reluctance to use the Act opportunistically. Furthermore, the Treasury in 2006 concluded that there was little that a PPP could do for New Zealand (Owles, 20008).

Broadbent and Laughlin (2005, p. 59) believe that the past experience with privatization contributes to this reluctance because if *the UK and Australian privatization programs were far from an unqualified success, New Zealand fared even worse*. The political and economic aftermath of New Zealand’s privatization programme and the association of PPPs with these debacles have a pessimistic effect on PPPs (Broadbent & Laughlin, 2003, p. 335).

Owles (2008) had another take on the slowness of PPP take-up, noting that the NZLTMA 2003 has not been applied because of high implementation costs, small market size, and the inflexibility of PPP arrangements (Owles, 2008). The Auckland Regional Council officers, for example, do not favour private sector involvement and they believe that there is *no advantage in using such a device [PPP] to complete Auckland's western ring motorway network by 2015* (Dearnaley, 2008). According to them:

“...Transit and Government funding agency Land Transport NZ have already in recent years developed procurement systems which are "much more flexible and innovative" than past practices in sharing risk between public-sector owners and private-sector road-builders. These had led to alliances in which public and private sector construction partners shared gains and losses in projects such as the Grafton Gully extension to Spaghetti Junction, which was completed under budget and before schedule” (Dearnaley, 2008).

Hence, the hold up for PPP development in New Zealand is also fuelled by the public belief that New Zealand has a better procurement method, namely project alliance, which does not involve private financing or transfer of ownership (OAG, 2006, p. 55).

Despite the opposition to utilizing PPPs for roading projects, there is some support for PPP in New Zealand. For example, it was likely to reduce the costs and increase the speed of project completion as expressed below:

“...the cost associated with a PPP procurement process was likely to be insignificant compared with potential savings, in which every 1 per cent of cost reduction would equal \$18 million. He said it was unlikely the project could be completed by 2015 without alternatives to full Government funding, and road tolls would need to be considered irrespective of whether a PPP was formed. Assuming tolls were to be adopted, a PPP would provide an opportunity to assess the desirability of transferring revenue risk from the public to the private sector” (Dearnaley, 2008).

This is one of the responses for PPPs with regards to the \$1.89 billion Waterview motorway tunnels project. The reported interviewee believes that to complete the project additional funding and road pricing will be unavoidable. Also arguing for PPPs, Tim Stone<sup>6</sup> believes that significant long-term cost savings would be available to taxpayers by allowing the private sector to supply expensive infrastructure such as new roads, schools, prisons, hospitals and military training (The Dominion Post, 2009). This is because the government will not have to pay the full amount of the delivered assets immediately since the selected private operator is paid an annual fee to provide the facilities, over a long-term contract of 15 years minimum (The Dominion Post, 2009). The potential for cost savings depends on the accuracy of the assumptions built into the chosen formula. Also, penalty

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<sup>6</sup> KPMG Chairman of Global Infrastructure and Projects

clauses<sup>7</sup> designed to combat underutilization of facilities' real capacity influence the net revenue to government (The Dominion Post, 2009). These penalties serve as continuous motivators for the service providers. However, it is important to note that PPPs are not meant for softer services such as clinical care because if these services are not profitable, the public sector ethos might clash with private sector motivation (The Dominion Post, 2009). The consequences of this motivation include exclusion of poorer public from much needed services. It is likely that these services will remain the responsibility of the government from start to finish.

Currently, the Government of New Zealand has also been showing interest in PPPs and is keen to use PPPs for prisons and schools (School property PPP moves to next stage, 2010). This appears to suggest that PPPs are seen as a rational choice for prisons and schools but not for roading projects. This might be due to a public aversion to road tolls.

Evidently, apart from the Central Government, the Local Government also has a key role to play in PPPs including existing and emerging initiatives, engagement in application processes for public broadband funding and its role in facilitating infrastructure deployment processes (Network Strategies, 2008, p. v). However, the government could be distorting the market by entering an agreement with a specific industry player or backing a particular technology (Network Strategies, 2008, p. 30). This relates to the need highlighted by Hammami et al. (2006) for a large market. So, Network Strategies suggests that it will be better to use technology-neutral competitive tenders in selecting private sector partners while focusing on the desired outcomes, thus granting flexibility in the private sector approach (Network Strategies, 2008, p. 30). The point here seems to be that a procurer should be neutral for fair competition. This means that there should not be any specific preferences that would cause favouritism or would appear to cause favouritism. This can often be obtained through market practices.

Network Strategies also noted that the government and users/customers would be locked in with the selected private sector partner for a long time. This in turn would tempt the private sector partner to want to be secured against some level of uncertainties. For this concern, it is advisable to (Network Strategies, 2008, p. 30):

1. separate parts of the PPP project, for example having different companies build and operate a network;

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<sup>7</sup> In the case of a hospital, the contract would allow for deductions for underutilization e.g. an operating theatre was out of service, or a ward was shut down (The Dominion Post, 2009).



2. consult industry beforehand regarding ownership, divesture and replacement rules, to be included in the PPP contract; and
3. limit the service contract to a number of years, after which the public partner determines whether to continue with the chosen private partner, or to conduct a new tender.

These issues suggest that the hurdles against PPPs in New Zealand are derived from scepticism about PPPs. They could distort the boundaries that differentiate the private sector from the public sector. Even so, the current government appears optimistic that PPP has a lot to offer for the betterment of New Zealanders. New Zealand acknowledges the following advantages and disadvantages (NIU, 2009, p. 12):

**Figure 2 Advantages and disadvantages of PPPs**

| <b><u>Advantages</u></b>   |
|--|
| <ol style="list-style-type: none"> <li>1. Whole of life cost savings i.e. construction and ongoing operating and maintenance costs</li> <li>2. Financing cost savings during construction</li> <li>3. Greater user benefits</li> <li>4. Potential access to additional revenue sources i.e. creativity to extract more value from the infrastructure via property development or advertising, etc</li> <li>5. Greater cost certainty, thus better decision making by the public sector</li> <li>6. Greater community benefits</li> <li>7. Potential on time and within budget completion</li> <li>8. Risk transfer that provides the incentive for obtaining the benefits mentioned above</li> <li>9. PPPs may offer finance for projects via off-balance sheet financing which would otherwise be unaffordable<sup>8</sup></li> </ol> |
| <b><u>Disadvantages</u></b>  |
| <ol style="list-style-type: none"> <li>1. Tendering and contracting costs</li> <li>2. Cost of contract variations i.e. the additional cost of changing contractual provisions</li> </ol>   |

<sup>8</sup> PPPs that are financed by service payments from government create a liability to make regular payments over the life of the project. For accounting purposes, these are treated the same way as the interest that is payable on government debt, giving rise to a similar liability on the Crown's balance sheet as if the project was financed with Crown debt. The provision of private sector finance merely strengthens incentives for obtaining the benefits mentioned before (NIU, 2009, p. 12).

### 3. Difficulties with contract enforcement and specification of performance dimensions

Based on the advantages, a PPP offers financial and societal benefits but its costs and contract enforcement difficulties appear significant in some areas, for example roading. Hence, these advantages and disadvantages will need to be properly weighed to avoid unnecessary PPP implementations.

#### **2.1.2. Origin of PPPs - Malaysia**

PPPs in Malaysia have resulted from Malaysia's previous privatization program. Malaysia focuses on Private Finance Initiative (PFI), a subset of PPP, to improve the shortfall of the previous privatization program meant for better value for money (VFM) and more stringent control over projects (Takim, Ismail, Nawawi & Jaafar, 2009, p. 105).

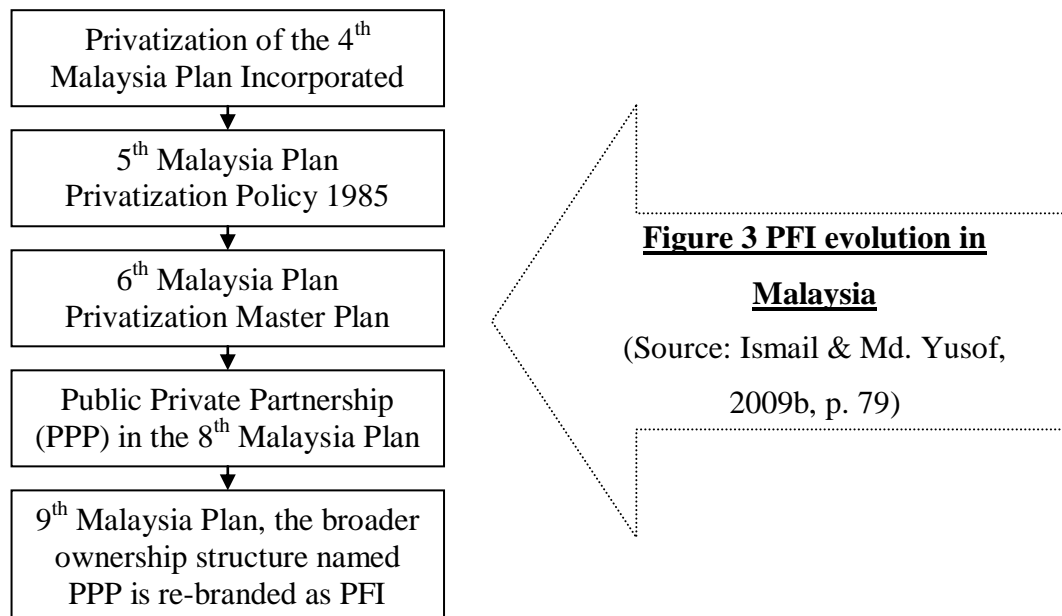
Performance deficiencies in privately-owned and privately-financed public transport companies such as Intrakota bus company, Cityliner (Park May) bus company and two light rail transit firms namely STAR and PUTRA necessitated government involvement in a PPP form. In recognition of the increasing need for better quality infrastructure, the Government of Malaysia (GoM) has been encouraging private sector participation to finance and contribute to materializing the desired infrastructure, instead of merely relying on public funds.

Vision 2020, as introduced by the fourth Prime Minister of Malaysia, to be an industrialized and fully developed nation by 2020 with growth rate goals of seven per cent per annum<sup>9</sup> (Nambiar, 2007, p. 18), will need both the GoM and private sectors to join forces. Since 1983, Nambiar (2007, p. 17) noted that the GoM's development policies and strategies have been focusing on synchronizing the private sectors and GoM. This can be seen in the 1983 Malaysia Incorporated policy, with cooperation between public and private sectors, economic liberalization and deregulation to improve investment policies for institutional reforms, and Malaysia's Public-Private Partnership<sup>10</sup> (PPP) Guidelines. In Vision 2020, 12 National Key Economic Areas (NKEAs) are being focused on with

<sup>9</sup> With the expectation of per capita GDP to reach US\$10,000 in 1990 prices compared to the US\$2,500 in 1991 at 1990 prices (Nambiar, 2007, p. 18).

<sup>10</sup> The Guidelines uses the general term PPP throughout its document whilst noting that there are subtle differences between Public Private Partnership and Private Finance Initiatives.

emphasis on private sector participation. They are Oil, Gas and Energy, Palm Oil, Financial Services, Tourism, Business Services, Improving Electronics and Electrical, Wholesale and Retail, Education, Healthcare, Communications Content and Infrastructure, Agriculture and Greater Kuala Lumpur (PEMANDU, 2010). This has seen five different plans developed progressively, as shown in Figure 3.



Following these plans, the 10<sup>th</sup> Malaysia Plan continues to incorporate PPPs in developing Malaysia. Malaysia's Economic Planning Unit (EPU) in 2006 defines a PFI in Malaysia as an arrangement involving the transfer of financial responsibility, capital investment management, services of public sector assets, construction, management, maintenance, refurbishment and replacement of public sector assets to the private sector. The private sector partner will receive an amount sufficient to ensure returns on asset investment along with lease charges that correspond with the level, quality and timeliness of service provision so that quality facilities may be transferred to the public sector when the concession period has ended (Ismail & Md. Yusof, 2009b, p. 78). According to Aziz Bahaman, vice President of Master Builders Association Malaysia (MBAM), a good PFI could tackle many of the weaknesses in the existing privatization projects and beneficially the GoM could be exempted from the financial and political costs of unsuccessful projects (Yusoff, 2007).

Another reason for PFIs is to increase competition among private enterprises and to encourage *bumiputera* participation (Ismail & Md. Yusof, 2009b, p. 79). Involving and encouraging private sector participation could help with the issues of the government's

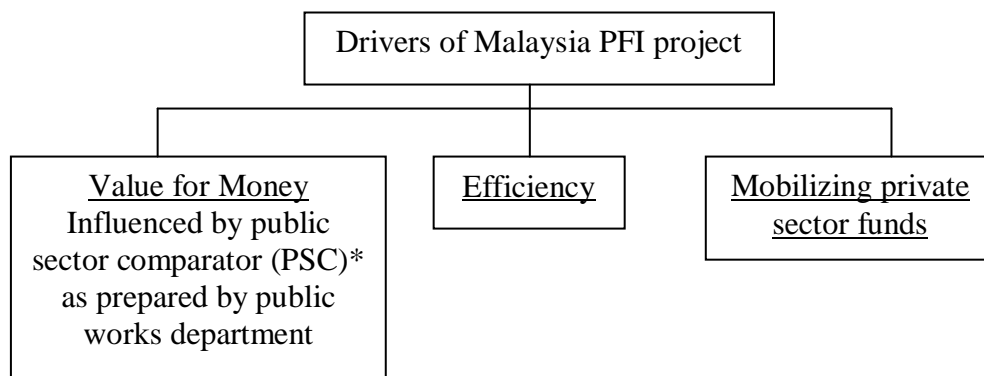
limited budget, escalated world oil prices, pressure to confront abandoned public projects and reduce government's financial burdens, and increased taxpayers' demand on the quality of infrastructure assets and services, because there is no cost to the government to use private sector sources in providing assets and services (Ismail & Md. Yusof, 2009b, p. 76). Although it might appear to be of no cost for the government to use private sector sources, it is likely that the private sector partner could have included the cost in the PPP contract as a rational choice by the private sector party.

Yakcop (2006b) notes that the GoM is financially willing to support strategic projects in which concession income may be lacking, based on merit. Hence, for selected projects, the private sector partners can expect to receive limited financial support from the GoM in partaking PPPs. As a result, infrastructure financing has since accelerated in highway construction, public transportation, ports, communications, water supply and power generation (Yakcop, 2006b). Public Works Department director-general Datuk Seri Professor Dr. Judin Abdul Karim also refers to PPPs as an exploration of the full potential of private sector management, commercial, creative skills, and not simply about the financing capital investments (Bigger role for private sector under 10<sup>th</sup> Plan, 2009). Hence, PPP funding will increase because PPPs also offer cost savings<sup>11</sup> for Budget 2010 and the costs can be spread over a longer period (Bigger role for private sector under 10<sup>th</sup> Plan, 2009). The savings in capital expenditure, thus the savings of public funds, has enabled the GoM to reallocate its limited resources to other sectors of the economy (Ninth Malaysia Plan 2006-2010, pp. 226).

Figure 4 summarizes PFI drivers in Malaysia (Takim et al., 2009, p. 107):

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<sup>11</sup> The savings related claim is not without disputes among authors. Some (e.g. Gibson, 2008, English, 2005) state that the public sector can access funding more cheaply. As is discussed in section 7.2, these authors deem it would be better if the public sector keep on taking on their role as public goods and services procurer instead of passing it on to the private sector.

**Figure 4 PFI drivers in Malaysia**

\* The PSC is discussed further in section 3.1.

## 2.2. Summary

In both countries, PPPs originated from the governmental obligation to serve the general public. In particular, infrastructure is needed for nation development and to support the lifestyle of the general public. However, the public funds available are limited. For this reason, the adoption of a PPP is expected to achieve these aims through quality and timely infrastructure as well as relieving the government from some of its current financial burdens. Recall that Hammami, et al. (2006) found that there are more PPP projects in an environment with large markets and high demand for infrastructure, governments burdened by high debts, macroeconomic stability (i.e. stable inflation), low corruption, strong rule of law, stable institutional and legal frameworks, and edifying past experience with PPPs. Apart from low corruption, Malaysia seems to have these determinants embedded in the country which could justify their preference for more PPPs. As for New Zealand, the major hindrance for PPP is the absence of a large market (Owles, 2008). Since Hammami et al. (2006, p. 20) found evidence that a large market is crucial for PPPs, this absence might provide the answer to New Zealand having few PPPs, but this will be explored further in this thesis. Public support is also lacking and Broadbent and Laughlin (2005) suggest this might be because of negative sentiment around privatization.

Without doubt, the private sector can assist in building and maintaining public assets and services delivery<sup>12</sup> as shown by Malaysia (where strongly developed plans are evident) and New Zealand (where the legislation and environment appear to support PPP, but few projects exist). Opting for PPPs is, unfortunately, not without its challenges. A government is still susceptible to other risks as PFIs allocate risks according to each party's ability to manage risks. Hence, there seems to be a need for a powerful and influential party with strong motivation to commit to PPP development. Although the GoM has been definite about PPP, especially PFI, the New Zealand Government (NZG) has yet to clarify whether it will be focusing on a particular subset of PPP. However, both governments, especially the GoM, appear to have accepted PPP as a rational choice for selected sectors in consideration of their countries' developments.

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<sup>12</sup> However, there is a limit to how far the private sector can get involved in public services delivery as some countries are more conservative with their frontline services.

### 3. Features of PPPs

The reasons for PPP have been presented and justified. Since there are reasons warranting the need for PPPs, countries will need to prepare a framework to guide PPP development. The framework should include features that will maximize the success and minimize risks of failure. Consistent with the rational choice theory, the features of a PPP are expected to contribute to its delivering an optimal outcome after evaluating the circumstances of each country.

Apart from the rational choice theory, transaction cost economics (TCE) predicts that different contractual problems generate different transactions. Consequently, each country is expected to have a different PPP framework because of their respective circumstances. Aubert and Weber (2001) presented an overview of the transaction cost theory based on Oliver Williamson's work. They mentioned Williamson's assumptions which are bounded rationality (*humans are unlikely to have the abilities or resources to consider every state-contingent outcome associated with a transaction that might arise*) and opportunism (*humans will act to further their own self-interests*). This is applicable to PPPs, where both partners cannot perfectly predict the future of their long term partnership and each has their own interests to pursue. This aspect of risk is further analysed in chapter 4.

Accompanying these assumptions are three variables affecting a transaction: namely frequency, uncertainty and asset specificity (Transaction Cost Economics, n.d., p. 2). Aubert and Weber (2001, p. 5) explain that *uncertainty exacerbates the problems that arise because of bounded rationality and opportunism*. Uncertainty in a PPP occurs due to the long term arrangement between the participants. In addition, these uncertainties give rise to costs. They note that *transaction costs arise for ex ante reasons (drafting, negotiating, and safeguarding agreements between the parties to a transaction) and ex post reasons (maladaptation, haggling, establishment, operational, and bonding costs)*. Each partner will try to minimize these costs from a PPP but each will also seek to reduce uncertainty. Consequently, similar to an organic structure<sup>13</sup>, the arrangement of a PPP should allow for changes via renegotiation during the course of the project.

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<sup>13</sup> An organic structure emphasizes participation and fits an environment with high uncertainty, high market participation, high technological change, long-term time orientation, and with employees who preferred autonomy and had high tolerance for ambiguity.

It was noted above that Hammami, et al. (2006) found that PPP projects thrive where there are large markets and high demand for infrastructure. Aubert and Weber (2001, p. 5) note that, with rational choice theory, the opposite of a large market also raises concern. Small numbers trading is concerning because *if only a small number of players exist in a marketplace, a party to a transaction may have difficulty disciplining the other parties to the transaction via the possibility of withdrawal and use of alternative players in the marketplace*. In relation to PPPs, when the numbers of market participants are insufficient, the aim for competitiveness in a bidding process could be undermined. Since it has been presumed that competition will bring in the highest quality at economic prices, without enough competitors, the prices would not be low as they could have been for the same quality.

Another aspect of PPPs also arises in TCE. This is the commitment of a non-investor to a transaction. Aubert and Weber (2001, p. 5) call this danger asset specificity, *the value of an asset may be attached to a particular transaction that it supports. The party who has invested in the asset will incur a loss if the party who has not invested withdraws from the transaction*. Consistently, these reasons are highly regarded in a PPP. Each potential partner arguably has their own method for handling every detail of each transaction with varying cost-minimizing approaches. They then added that *decision-makers must weigh up the production and transaction costs associated with executing a transaction within their firms (insourcing) versus the production and transaction costs associated with executing the transaction in the market (outsourcing)*.

Hence, a PPP framework should be structured in ways that regard the TCE issues including bounded rationality, opportunism, uncertainty, the number of market participants and asset specificity. Jefferies (2006, p. 453-454) presented a list of success factors that would be beneficial for this purpose. For an example, bounded rationality issues would require expertise and transparency to maximize fore-knowledge. Opportunism could be minimized with shared authority, appropriate risk allocation and a good partnership culture to refrain unnecessary opportunistic behaviours. The issues with frequency, uncertainty and asset specificity could be dealt with by political stability and support, a comprehensive feasibility study, technical innovation, and a strong private consortium.

These requirements exist in New Zealand and Malaysia to a certain degree. However, the deciding factor will be on the ability to identify and apply these factors rationally according to the changing environment. This is especially so when the circumstances of both countries are affected by external factors such as global recessions or natural disasters.



For a PPP to succeed, both government and private sectors will need to work together to avoid substandard works. There should be an acceptance of the limits of both partners thus allowing them to react optimally and practically based on the information that they have gathered for PPP development. Also, the success factors of PPPs may vary across countries and thus the variation should be rationally incorporated in developing PPPs. This chapter is intended to introduce and evaluate the features of PPP as outlined by the PPP authority in both countries. As mentioned before, a well developed PPP framework should include features that would maximize success and minimize risks. Consequently, this chapter also suggests that the features of PPPs are influenced by rational choice theory and TCE.

### 3.1. Features of PPP - New Zealand

A PPP authority should be present in PPP-adopting countries to take charge of PPP development. For this, the National Infrastructure Unit (henceforth NIU) of the Treasury is responsible for PPPs in New Zealand. It specializes in PPPs and provides economic evaluation, financial assessment, and advice on all PPPs. However, the NIU will not contract for projects itself due to its budget constriction, so PPP contracts will be entered into by line agencies. These departments and agencies are expected to consult the NIU early in the development of a PPP proposal, and to allow the NIU to include an experienced officer in the project steering and working groups (NIU, 2009, p. 3). The presence of an NIU officer in every PPP project is intended to ensure the optimal choice is chosen at each PPP stage. Also, Cabinet approval is needed for in-principle funding and to invite expressions of interest (EoI) (NIU, 2009, p. 5). Other major stages in developing PPPs (NIU, 2009, p. 5) are shown in Figure 5.

**Figure 5 Major stages in a PPP development**

| <b><u>Stages</u></b> | <b><u>Key Tasks and Issues</u></b>  |
|----------------------|---|
| The Service Needed   | <ul style="list-style-type: none"> <li>✓ Identify service needs</li> <li>✓ Focus on outcome and outputs</li> <li>✓ Consider broad needs, over time</li> <li>✓ Allow scope for innovation</li> </ul> |
| Procurement Options  | <ul style="list-style-type: none"> <li>✓ Public provision or contract out?</li> <li>✓ Are there 'specific assets'?</li> <li>✓ Conventional procurement or PPP?</li> </ul>                           |

|   |   |
|---|---|
|   | <ul style="list-style-type: none"> <li>✓ Allow scope for innovation</li> </ul>  |
| Business Case<br>(Stage 1)                            | <ul style="list-style-type: none"> <li>✓ Evaluate benefits, risks and costs of preferred option against other options, including status quo</li> <li>✓ Evaluate procurement options</li> <li>✓ Obtain funding and project appraisal</li> <li>✓ Begin development of PSC<sup>14</sup></li> </ul> |
| Project<br>Development                                | <ul style="list-style-type: none"> <li>✓ Assemble project team</li> <li>✓ Develop project plan</li> <li>✓ Further develop the PSC</li> <li>✓ Develop commercial principles</li> <li>✓ Consultation</li> <li>✓ Develop invitation for EoI<sup>15</sup> and evaluation criteria</li> </ul>        |
| Business Case<br>(Stage 2)                            | <ul style="list-style-type: none"> <li>✓ Seek approval to issue the EoI</li> <li>✓ Obtain delegated authority to commit</li> </ul>  |
| Bidding Process                                       | <ul style="list-style-type: none"> <li>✓ Evaluate responses and develop a shortlist</li> <li>✓ Develop RFP<sup>16</sup> and contract</li> <li>✓ Seek approval to issue the Project Brief</li> <li>✓ Evaluate bids</li> </ul>  |
| Project Finalization<br>Review<br>Final Renegotiation | <ul style="list-style-type: none"> <li>✓ Confirm achievement of policy intent</li> <li>✓ Probity review</li> <li>✓ Report to ministers</li> <li>✓ Execute contract</li> </ul>   |
| Contract<br>Management                                | <ul style="list-style-type: none"> <li>✓ Formalize management responsibilities</li> <li>✓ Monitor contract performance</li> <li>✓ Manage variations</li> </ul>  |

These major stages seek to deal with bounded rationality, opportunism, frequency and asset specificity. The earlier stages seek to ensure that a PPP project is rational while taking into account other possibilities and other potential issues. The middle stages are dedicated to creating a plan to maximize success and the last stages are about earning political support for the management of the PPP project. It is crucial that a PPP project is justified as necessitated and approved by the Cabinet because a PPP failure can be very costly. Political support is required for PPPs especially at the early stage of PPP

<sup>14</sup> Public Sector Comparator

<sup>15</sup> Expression of Interest

<sup>16</sup> Request for Proposal

implementations which will inevitably involve high costs along with high possibility of failures. As proven by the UK and Australia, where there is a political will, there is a way. Since the ultimate accountability lies with the government, the NZG will need to be well informed and be aware of the consequences of pursuing a PPP.

### 3.1.1. Procurement options

In preparing for these stages, issues to be considered include reputational risk, financial impact, accounting treatment and appropriation, and public sector comparator (PSC) (NIU, 2009, p. 13-14). Additionally, to pursue a PPP, the procurement decision framework (shown in Figure 6) would be helpful (NIU, 2009, p. 7):

**Figure 6 The procurement decision framework**

| Characteristics<br>Procurement type                         | New service | Specified outputs/<br>outcomes | Specific assets | Durable service |
|---|-------------|--------------------------------|-----------------|-----------------|
| Public provision  | ✓           | ✗                              | ✗               | ✗               |
| Short term service contracts<br>(up to 10 years)            | ✓           | ✓                              | ✗               | ✗               |
| Let separate construction and<br>service delivery contracts | ✓           | ✓                              | ✓               | ✗               |
| Long term contracts (PPPs)                                  | ✓           | ✓                              | ✓               | ✓               |

This framework provides the characteristics or the requirements for a PPP project approval. In selecting projects to be delivered via a PPP, New Zealand requires the project to deliver a new service with specified outputs/outcomes for a specific asset that is capable of long term services. This is because a PPP is not suitable for all projects. Thus, the framework gives some idea about the type of projects that could yield positive results if delivered via a PPP and when other arrangements might be more appropriate. Also, a preference for a PPP must be preceded by evaluation of the following (NIU, 2009, p. 9-11):

1. whole of life cost<sup>17</sup> minimization;
2. financing cost optimization;

<sup>17</sup> The total costs of owning an asset for its whole life.

3. greater cost certainty;
4. maximization of user benefits;
5. high bidding and contracting costs;
6. high cost of contract variations; and
7. difficulty of contract enforcement.

The evaluation of these factors enables the identification and minimization of total costs without distorting quality. Identifying and valuing costs for a long term PPP involve uncertainties that lead to insecurities to both partners. Hence, a PPP contract includes actions to be taken by both partners in unforeseen events. These can be difficult to enforce as each contract is based on a case-by-case foundation. This is especially so for major and costly projects. These stages and a framework are meant to identify as many issues as possible so that the best method to deliver infrastructure is chosen. This is because entering into a PPP arrangement involves significant costs and a long term commitment.

### **3.1.2. Project development and business case**

A public sector comparator (PSC) is commonly used to determine whether a project would be better off with or without a PPP. New Zealand's PSC consists of (NIU, 2009, p. 15):

1. construction and operating costs of a project;
2. provision for competitive neutrality adjustments to remove any advantages or disadvantages that accrue to a public sector procurer by virtue of its public ownership; and
3. provision for any additional costs and risks that would be transferred to the private sector partner under a PPP.

These factors are added as costs to the PSC because the public sector partner would have to bear the costs of any risks that occur under conventional procurement (NIU, 2009, p. 15). A discount rate is applied to value the project at its present value and included in the PSC. The PSC provides valuable information for identifying and costing all project risks as decisions are made based on available information, and bids are evaluated against a common benchmark (NIU, 2009, p. 15). This thesis does not cover PSC in great detail but future research is expected to present a better understanding of the preparation and the foundation of assumptions which is expected to vary across countries in designing PSC.

For a PPP, the NIU requires engagement of advisors<sup>18</sup> to add value to PPP projects, commercial principles, and market sounding (NIU, 2009, p. 16-21). These include allocating risks wisely, maximizing innovation, ensuring that the contractors and SPV have sufficient capital and capability to deliver, sharing excess profit/revenue between partners, avoiding tax exploitation, and minimizing subsequent negotiations. The NIU also emphasizes that payments commence after the service is available and the amount payable will be proportionate to the delivered quality and quantity of units. The intention here is to ensure service delivery as contracted. In consideration of the long term agreement, the NIU adds that payment mechanisms would be flexible to accommodate future requirements without negotiating a separate arrangement (NIU, 2009, p. 16-21). The NIU then discusses market sounding as a consultation to fairly include the private sector, key advisers, associations, or specific companies for key issues like the availability of industrial skills or a forum organization for interested parties to provide public input (NIU, 2009, p. 21). The willingness to allow for inputs from affected parties is commendable as this effort welcomes involvements from interested parties. Beneficially, pertinent issues could be discussed from both sides as the NIU focuses on minimizing the risks of PPP failures by emphasizing precautions that both partners should be aware of as made apparent under the commercial principles.

### **3.1.3. Bidding process through to contract**

Bidding process<sup>19</sup> is another stage that requires special attention because bounded rationality starts here. This stage needs as much information as possible to assist judgement, but it is impossible to be informed of everything. Since it is the first stage involving a potential private sector partner, a proper appraisal is expected as failure to rationally choose a partner at the very beginning could have a pessimistic snowball effect. Hence, the potential partner's level of market interest, financial capacity, technical capability, understanding of government requirements, resources to deliver the project, and market soundings will be studied. Furthermore, entities with an equity stake in a bidding consortium should be independent of the parties that have equity stakes in other consortia to avoid conflict of interest. As for the project finalization review and final negotiation, negotiations can be minimized or avoided if potential bidders are allowed to comment on the draft contract before the issuance of a Project Brief. This encourages all proposed

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<sup>18</sup> Refer to [http://www.hm-treasury.gov.uk/d/PPP\\_TTF\\_Technote3.pdf](http://www.hm-treasury.gov.uk/d/PPP_TTF_Technote3.pdf) for details.

<sup>19</sup> It includes EoI, request for proposals (RFP), and bid evaluation (NIU, 2009, p. 23-24).

changes to the contract to be accompanied by a dollar adjustment to the bid price that would leave the bidder indifferent between having the amendment and not having it (NIU, 2009, p. 25). Consequently, the government could then decide on changes without further negotiation (NIU, 2009, p. 25). Also, a good contract management establishes better performance monitoring against KPIs, payment approvals and contract variation dealings (NIU, 2009, p. 26) (these are discussed in chapter 5). The NZG should also be protected from legal risk and re-transfer of risk back to the NZG in drawing up the contract (NIU, 2009, p. 26). This stage welcomes the potential private sector partners to contribute from the early stage thus informing the NZG of their actual capabilities and at the same time allowing the NZG to react optimally and protect itself against avoidable and unnecessary risks.

The described stages for PPP development may be seen as the resulting outcome in rationally considering PPPs for quality infrastructure. Complementary to the presented stages is a Gateway Review Process for quality assurance of large or high risk state sector projects. This review process requires six separate reviews by independent experts whose reviews will be confidential to all except for the project's senior responsible official (NIU, 2009, p. 3). Having reviews from independent experts will further inform any decision made for or against PPPs which could weaken any intervention from personally interested individuals (opportunism), thus allowing better judgment to either accept or reject a PPP.

### **3.1.4. Summary of PPP process**

Fundamentally, there are three stages to using New Zealand public funds (OAG, 2008a, p. 11). The first is the availability of different funding options and their respective significance i.e. make or buy. Secondly, the need for a specific strategy for appropriate guidance and management. Thirdly, rationalization for the funding, the type of relationship involved, and the form of funding arrangement that will best fit with the goal and relationship. These stages ensure that the allotted funding will be wisely used and geared towards the public's satisfaction. Although a normal PPP requires the private sector partner to fund the project entirely or partly, it is common for the public sector partner to prepare financially for the possibility that it might need to take over the project if its partners fail to fulfil their contracts. The main concern in using public funds is VFM<sup>20</sup> attainability as it aims for the best possible outcome without wasting resources, by considering the total

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<sup>20</sup> Value for money

costs of ownership or whole-of-life cost, benefits of the arrangement, and contribution to the desired outcomes (OAG, 2008b, p. 6). A competitive tender for merely the lowest price does not guarantee VFM because the most appropriate procurement method for the risk and value of the procurement may not be the cheapest (OAG, 2008b, p. 6) as it depends on the ability of the partners to utilize available resources wisely. Hence, the need for a well developed procurement framework that could maximize VFM achievability by assigning responsibilities to each partner's capabilities.

Prior to New Zealand's PPP Guideline, only the NZLTMA 2003 was relevant for a PPP (Owles, 2008). It specifies that a PPP agreement must contribute to economic development, ensure safety, personal and public security, environmental sustainability, complement existing transport strategies and recognize available alternatives, as well as taking into consideration public consultation (Owles, 2008; NZG, p. 74). These considerations signify that a PPP should be arranged in ways that are relevant to New Zealand's environment. Additionally, NZLTMA 2003 also prohibits a concession agreement (CA) from providing a disincentive for the alternatives, such as deterring a relevant authority from procuring rival infrastructure or a disincentive for a person to pursue other sustainable transport options e.g. public transport (NZG, p. 74). Accordingly, a CA's terms and conditions must include those approved by the Minister and be consistent with NZLTMA and other relevant enactments (NZG, p. 77).

Also, a CA must not exceed 35 years, but a subsequent extension is allowed for up to 10 additional years. This extension is available for a CA that has been operating for more than two-thirds of its term. The extension will be granted if applied prior to agreement cessation and there are exceptional circumstances requiring the extension (NZG, p. 74). The same rule applies to leasing of associated land<sup>21</sup> which will be 35 years maximum with a maximum 10 years extension (NZG, p. 79). This period is inclusive of construction and operation. It is expected that this period is sufficient for the private sector partner to complete the construction and make it operational, whilst allowing them to recover their costs. The NZG has made it clear that the land and road in a PPP agreement will be publicly owned and leases of the land will be contract-restricted (Owles, 2008). This means that the private sector partner will not have direct rights to the land or the road. Additionally, only with the Minister's prior written approval can a public road controlling

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<sup>21</sup> Land includes an estate, right, title, or interest in land; and a road or portion of a road; and land acquired by the road controlling authority under the Public Works Act 1981 (NZG, p. 79).

authority proceed with a CA. The approval will be granted if the Minister is satisfied with preset conditions that protect public access to the associated new road, conditions that relate to the apportionment of risk, responsibilities and rights between parties, civil penalties specification for breach of conditions and disputes-resolving procedures (NZG, p. 74). Hence, it is important to ascertain that the Minister is informed of any conditions that could affect the approval.

In a media statement, NZCID<sup>22</sup> (2009) announced that the NZLTMA 2003 is long overdue for a review. The Act was intended to *improve the flexibility of land transport funding, including provisions enabling new roads to be built on a tolled or concession basis*. However, it contains barriers to using tolling, borrowing and PPPs to fund transport projects due to the complexity in its administration which requires repetitive consultation and approval processes which resulted in the absence of PPP concessions with only one completed public toll road (NZCID, 2009). The NZG appears extremely careful when it comes to roading projects via a PPP. Due to the nature of a PPP which requires collaboration between the private sector and public sector partners, there will always be the concern that the partnership might be undermined by profit motivation of the private entities when it comes to tolling. Hence the rigorous tests to make sure that a PPP is essential for a roading project as witnessed in the Waterview project.

It has been reported that apart from roading and water projects, the private sector appears interested in PPPs (OAG, 2006, p. 20). As noted by Hammami et al. (2006), PPPs work best with many private entities in a large market that creates sufficient competition to achieve high quality at lower prices. Arguably, New Zealand may not have the size or the number to attract enough interest from domestic or international companies. Plus, there are constraints and substantive limits on partnering arrangements concerning water and wastewater services<sup>23</sup> and prisons management<sup>24</sup> (OAG, 2006, p. 21) which limit PPP development in New Zealand. However, the OAG (OAG, 2006, p. 20) seems optimistic

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<sup>22</sup> NZCID stands for New Zealand Council for Infrastructure Development.

<sup>23</sup> A local authority or council-controlled organization cannot use assets of its water services as security, and cannot vest ownership in, or lose control of water services assets. Contracts and partnerships are permitted for any aspect of the operation of a water service, for a term of up to 15 years, but the local authority must keep control of all matters relating to pricing, managing, and setting policy on the delivery of water services.

<sup>24</sup> The Corrections Act 2004 prohibits the Crown from entering into any contract to manage any prison. Even if the ongoing service provision aspect of a partnering arrangement were for other services, the Crown's retention of control over management may make this difficult in practice.



that with time<sup>25</sup> New Zealand will be better prepared for PPPs. After conducting research<sup>26</sup> to assess private sector interest in PPPs, the OAG recommends that New Zealand could either co-operate with Australian governments to establish one Australia/New Zealand market for PPPs, or bundle small contracts into a larger package to make them more commercially attractive, or create small-scale versions of PPPs (OAG, 2006, p. 20). These options accentuate the need for a larger market before PPPs become viable in New Zealand. There is some doubt whether a small-scale version of PPPs would work. This is because a PPP is commonly used for large projects requiring high skills and high costs as practised in the United Kingdom, since a PPP has higher success rates with complex and costly projects. This raises some doubts of whether a PPP would be a rational choice for New Zealand. Further, it has been suggested that the general public may not give consent to these options, seeing the high likelihood that the people of New Zealand value independence and least costly method of procurement without much reliance on the private sector as contested by the Auckland Regional Council officers (Dearnaley, 2008).

### **3.2. Features of PPP - Malaysia**

A PPP Unit is the centre of reference for privatization and PPP programs. It is established to foster strategic partnerships with the private sector in delivering privatization and PPP programs, and to operate in a transparent manner to achieve recognition for Malaysia's innovation, leadership and expertise in implementing privatization and PPP programs (3PU, 2010). Since the unit is still relatively new, there might be a lot to learn about PPPs from other countries with PPP experiences while taking into consideration Malaysia's circumstances. Its existence should allow an on-going evaluation on PPPs and their progressions. Other central agencies such as the Ministry of Finance, the Attorney General's Department, the Ministry of Public Works, the Valuation Department, the Federal Department of Lands and Mines and the relevant client agencies will play supporting roles (Ninth Malaysia Plan 2006-2010, 2006, pp. 232). These agencies will be

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<sup>25</sup> Time will be needed in New Zealand to build a local market with clients, contractors, and financiers who are experienced in the use of partnering, especially arrangements that have the characteristics of PPPs. Establishing a market for long-term partnering arrangements, especially those that involve private financing, needs significant involvement from experienced companies, which are likely to be based overseas. However, the international partnering market is competitive, and international bidders and funders will invest their time and money in New Zealand only if they have the confidence that there is a real opportunity.

<sup>26</sup> Despite security of private sector partners' investments, it is quite unlikely that the general public would give consent to these options, seeing the high likelihood that the people of New Zealand value independence and least costly method of procurement without much reliance on the private sector.

helpful in making informed decisions as they are specialized departments. The involvement of other agencies (similarly to New Zealand) hints that the PPP unit cannot exist on its own and this encourages more communications between each agency, allowing for better informational flow. These agencies should consider the environment needed for a successful PPP and the need to educate the public sector about PPP concepts to rationally justify and encourage PPPs.

In Malaysia, a PPP is structured to warrant commitment, better control, management and project supervision (3PU, 2009, p. 9). Figure 7 shows the way this should work:

**Figure 7 The structure of a typical PPP in Malaysia**

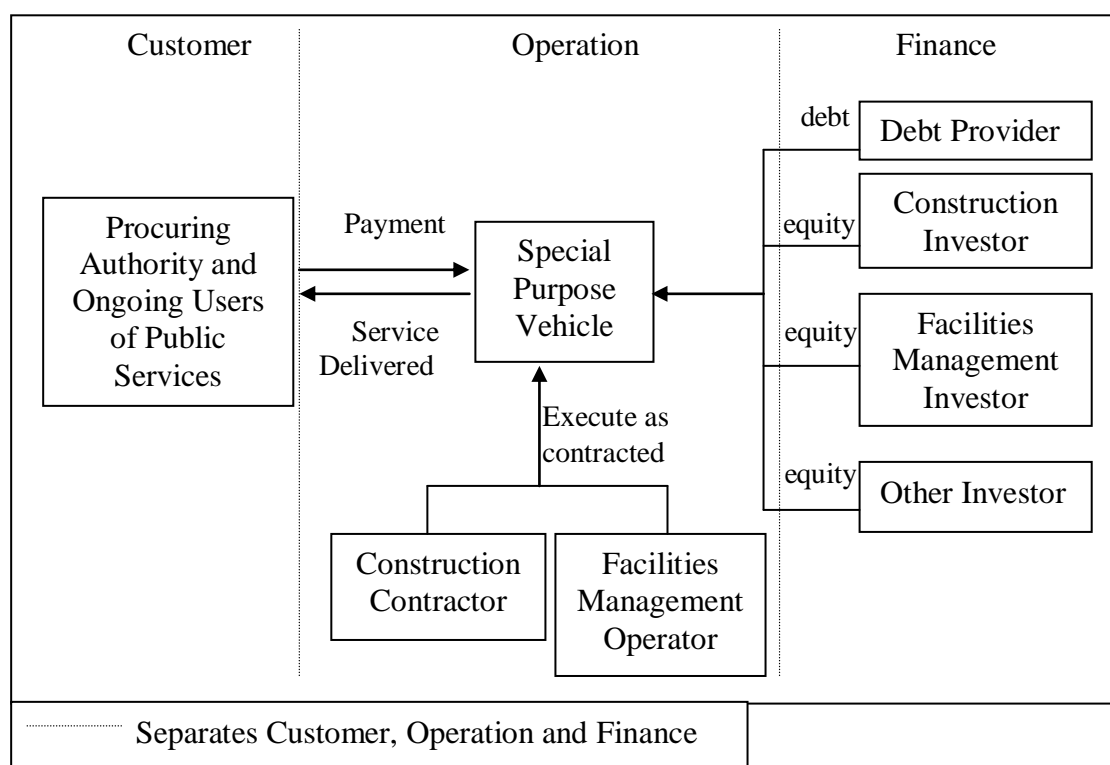


Figure 7 shows the main players in a typical PPP and their responsibilities; customer, operation or finance. The roles played by those mentioned above are explained below (3PU, 2009, p. 10):

a) Special Purpose Vehicle (SPV):

1. raising the funds to develop and maintain the assets;
2. making payments to the subcontractors, financiers and other creditors;
3. delivering the agreed services to the public sector according to the levels, quality and timeliness of the service provision throughout the contract period;

4. ensuring the assets are well maintained and available for use throughout the concession period; and
  5. ensuring that revertible assets/facilities are transferred to the public sector in the specified conditions at the end of the concession period.
- b) Financiers:
1. the financing of the project is provided by a combination of equity investors and debt providers.
- c) Construction Contractors:
1. to carry out construction works according to the contract with the SPV
- d) Facilities Management Operator:
1. to carry out comprehensive facilities management of the assets according to the contract with the SPV.
- e) The Public Sector is responsible for:
1. identifying, assessing and prioritizing projects for implementation via PPP;
  2. preparing and managing the projects for competitive bidding process;
  3. providing clear objectives and scoping of the projects, output specifications, payment mechanism and KPIs;
  4. ensuring equitable and optimal allocation of risks;
  5. contract management and performance monitoring; and
  6. safeguarding public interests.

This structure provides the basic PPP arrangement but the details will be dependent on projects and industries. Knowing the main players along with their respective roles and responsibilities assist with PPP management, and also educates the general public about PPPs, its players and what can be expected from them.

Drawing on rational choice theory, value for money (VFM) is the most attractive reason to opt for PPP. It reconciles the procurer's need for quality and provider's desire for profit and also fits with rational choice theory. To take on a PPP project, VFM must be achievable, as evaluated against PSC. This means that the cost of capital expenditure and the maintenance of the project through its whole life (prior to transfer to the Government) must be lower than the determined PSC (Jayaseelan & Tan, 2006, pp. 97). Although PSC can be imprecise due to the underlying assumptions and subjectivity of, for example, the

discount rates, it estimates the amount that the government would have had to spend had it taken on the projects alone. When PSC is indeterminable due to lack of government expertise or experience, consultants independent of the bidding private companies will be hired for PSC estimation to ensure fair tender giving processes (Jayaseelan & Tan, 2006, pp. 97). Otherwise, the Public Works Department will assist in PSC preparation for standard construction projects (Jayaseelan & Tan, 2006, pp. 97). The GoM reckons that VFM needs efficient allocation of risks, whole life service approach, private sector innovation and management skills, synergies from inter-linking the design, finance, construction and operations. These are weaved into some of the key features/characteristics of PPP (3PU, 2009, p. 5-6):

1. relationship between public and private sectors is based on partnership;
2. public sector procures specified outputs or outcomes of a service for a concession period;
3. private sector determines the required inputs to achieve the specified output and it may introduce innovation into their designs and development to reduce overall costs;
4. payment for services is based on pre-determined standards and performance;
5. promotes 'maintenance culture' where the concessionaires will be responsible for the long term maintenance of the assets throughout the contracted operational tenure;
6. integration of design, construction, finance, maintenance and operation – total package;
7. transfer of assets at the end of the concession period is optional for the Government;
8. optimal sharing of risks whereby risk is allocated to the party who is best able to manage it; and
9. Whole Life Cycle Costing (WLCC); PPP projects are usually awarded based on lowest total cost over the concession period compared to lowest construction costs under the traditional procurement method.

These characteristics show the need for the procurer to get the best out of its partners without constricting their process so that PPPs will not only be a rational choice for the

procurer, but also the partners. Pursuing VFM allows for optimal allocation of risks between the public and private sector, the long term nature of contracts and WLCC, output specification which allows bidders to innovate, competition that provides fair value costing of the project, performance-based payment mechanisms, and private sector management expertise and skills (3PU, 2009, p. 6). Indeed, VFM achievability is one of the main considerations in opting for a PPP. If it is deemed unlikely to achieve VFM, going for a PPP will be meaningless and unlikely to succeed. This is why GoM requires bidders with high *technical merit and capabilities with emphasis on VFM<sup>27</sup> and affordability<sup>28</sup>* (Ahmad Badawi, 2009, p. 2). In addition to these characteristics, the GoM requires the PFI prerequisites already noted (Ahmad Badawi, 2009, pp. 2-3): a centralized unit within the public sector to supervise and monitor PFI and emphasizes the contract monitoring process during the operational phase especially on the availability and performance regime. This requires the public sector to have a comprehensive understanding of a long term service delivery model based on a PFI framework defining relevant objectives, procedures and policies and a transparent and equitable PFI processes to ensure that the desired results are achievable. In order to do this, the government needs a strong drive to introduce new changes for taxpayers and to continue to commit to the PFI to ensure its success.

These prerequisites ensure that both partners are well prepared for PPPs. Otherwise the consequences could be severe. Hence, the GoM will be playing an active role in a PPP by monitoring the project closely and ensuring that there is an indisputable need for a PPP. Since a PPP failure could cost a lot, a government has to be committed and optimistically able to learn from its mistake to improve its PPP framework.

Malaysia has experienced DBFO (Design, Build, Finance, Operate), BOO (Build, Own, Operate), BOOST (Build, Own, Operate, Subsidise, Transfer) and BOL (Build, Operate, Lease) (Ismail & Md. Yusof, 2009b, p. 76) and has benefited from them. Particularly, the GoM has a special interest in PFIs. This is because PFI arrangements maximize quality by requiring facilities maintenance, output specifications and clearly stipulated key performance indicators (KPIs) for regular performance evaluation and audit of the privatized entities to ensure standards and KPIs are satisfied (Ninth Malaysia Plan 2006-

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<sup>27</sup> The optimal combination of whole life cost and quality to meet the users' requirements.

<sup>28</sup> Dictates the limit that the public sector is willing to pay for the procurement and the price proposed by each bidder must be within the budget of the public sector.

2010, 2006, pp. 229). These requirements oblige both partners to be aware of their project's progression in order to detect and react to emerging crises immediately. The Ninth Malaysia Plan 2006-2010 (2006, pp. 225) reveals that most of the road projects in Malaysia utilized build-operate-transfer (BOT) method which holds the private sector responsible for, among others, construction, operation, maintenance and funding of the facility. In return, depending on the contract, the private sector may collect tolls from road users during the concession period. At the end of the contracted period, the facilities are transferred to the Government at zero cost<sup>29</sup> (Ninth Malaysia Plan 2006-2010, 2006, pp. 225). As straightforward as it sounds, there have been circumstances in which road users had to bear increasing toll rates and a prolonged tolling period, to cover road maintenance costs mostly due to road accidents. These circumstances normally call for contract renegotiation. There is a standard format for privatization agreement in which renegotiation is made with mutual consents to improve terms and conditions, to address revenue sharing with the GoM after an agreed threshold is reached, to adjust performance-based tariff, to abolish exclusivity in the service provision, and to improve quality and service standards (Ninth Malaysia Plan 2006-2010, 2006, pp. 226). This is an example of the need to factor in the presence of long term uncertainties requiring renegotiation as shown in TCE. As the GoM might need to consider the reputation and longevity of its partners, the private sector partners might need to make changes according to the ruling political party following five-yearly elections.

Similar to New Zealand requiring ministerial consent, proposed PPP projects must satisfy ministries' statement of needs and government priorities (Economic Planning Unit, 2009b, p. 8). Accompanying this, a project will be chosen after considering socio-economic impacts, VFM and cost savings to the GoM, quick project delivery and service enhancement, increased level of accountability, efficiency and effectiveness, and the need for a PPP (3PU, 2009, p. 5). A completed PPP proposal should go directly to the relevant ministries or agencies detailing required information (see appendix A) such as a business plan and a financial plan (3PU, 2009, p. 7-8). The proposed project will be filtered based on clearly identified and quantified output specification. The economic life of the asset or service should be at least 20 years. Projects with technological obsolescence risk will be discarded, and the project sponsor must be financially secured with a paid up capital of the SPV to be at least 10% of the project value (3PU, 2009, p. 8). These and more are specified

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<sup>29</sup> Jalan Kuching, Jalan Pahang and Jalan Cheras toll roads were transferred to the Government and the toll charges eradicated (Ninth Malaysia Plan 2006-2010, 2006, pp. 226)

in *Garis Panduan Kerjasama Awam Swasta*<sup>30</sup> (Public Private Partnership Guideline). It describes the PPP framework, payment principles, project valuation criteria, project execution structure, processing procedure and execution, and project proposal preparation guideline (Economic Planning Unit, 2009b, p. 6). The publication of the guideline marks PPPs as a beneficial procurement method in Malaysia. This has affected the 10<sup>th</sup> Malaysia Plan as growth of public investment would be reduced to 0.7 per cent per year and the investment will be specified for certain projects; poverty eradication, personnel development, and improvement of social and physical infrastructure (Economic Planning Unit, 2009a, p. 5). As noted, PPPs allow for reduction in public investment as some of the funding will be borne by the private sector partners. This permits the GoM to smooth cash flows thus improving the level of national debt.

To support PPP/PFI growth in Malaysia, the GoM uses the Employees Provident Fund (EPF), a state-run pension scheme. Because of EPF, some authors regarded Malaysia's PFI *deviates somewhat from the ideal PFI principle* (Jayaseelan & Tan, 2006, pp. 96). Conflicting interest might be another issue to be considered with this arrangement which could question any objectivity in choosing which public department and which projects to pursue a PPP. According to Takim et al.'s research (2008, pp. 75), the majority of the public respondents (97 per cent) strongly disagree to using EPF as the source of finance in delivering Malaysian public infrastructure. The respondents believe that the government does not have to invest through its government linked companies and be exposed to risks unnecessarily. In contrast, the majority of the private sector respondents believe that *EPF has the best source of funding for a PFI project* and that *the investment would not bring losses to the EPF, instead EPF and its contributors will gain benefits and higher dividends* (Takim et al., 2008, pp. 75). This proves that the major concern in Malaysia's PPPs is not the PPPs themselves but the participation of EPF. The EPF is deemed crucial to fund PFI projects in Malaysia partly because the local financing bodies are still relatively inexperienced and hesitant to finance the long term PFI projects (Takim et al., 2008, p. 73). This suggests that EPF is a temporary measure that allows the financing bodies to observe, learn and react according to PPP development in Malaysia. The EPF has enabled

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<sup>30</sup> The government announced PFI adoption would be from 2006, but the guideline was made available and distributed only in 2009. The delay of the guideline might cause the public to question the commitment issues of the government but at the same time, the public has been used to the delay in governmental services which makes them cynical of government decisions. There had been a number of readings that are one reason why it took so long for a PPP guideline. For this reason, it is expected that a number of authors will find it easier to criticise the guideline which appears to lack the country specific details that would make it different from any other existing PFI practices.

marginally non-viable PFI projects that could enhance future national competitiveness, generate new sources of growth, induce high spill over effects and create sustainable employment opportunities to become viable (Loong, 2009).

Additionally, as shown in Figure 7 the GoM introduces a SPV called PFI Sdn Bhd<sup>31</sup>, a wholly owned subsidiary of the Ministry of Finance (MoF), with a key role in the projects implementation and it will be responsible for its PFI project (Jayaseelan & Tan, 2006, pp. 96). The loan from EPF will be channelled via PFI Sdn Bhd to the builders and contractors (Takim et al., 2008, p. 73). PFI Sdn Bhd seems to be an intermediary between the procurer and the provider with an active role in ensuring PPP success as it could filter and enhance information. Future research should look into this arrangement more closely to better understand its pros and cons.

Malaysia's PFI is specified for the Malaysians (Jayaseelan and Tan, 2006, pp. 96) to cater for nation development towards Vision 2020. Noting that PFI Sdn Bhd is a GoM-owned firm, it is improbable that the loans will go bad (Jayaseelan & Tan, 2006, pp. 99). The EPF is covered from lending exposure as it deals directly with PFI Sdn Bhd and excluded from bearing construction risks thus, making PFI investment a *virtually risk-free investment* for the EPF (Jayaseelan & Tan, 2006, pp. 99). Seeing that the EPF does not seem to have project selection expertise to make informed judgment on matters like monitoring, the role of EPF is limited to fund lending as PFI Sdn Bhd takes on more active roles; supervises, undertakes PFI programme and finances the selected contractors for PFI projects (Jayaseelan & Tan, 2006, pp. 99). According to an EPF representative, a PFI was profitable for EPF because the allocated RM20 billion under 9MP represented 6.6 per cent of EPF total funds, which on the money market, the EPF would earn about 4 per cent returns (Jayaseelan & Tan, 2006, pp. 99) but it could receive 5 to 6 per cent of the total profits gained from PFI investment (Takim et al., 2009, p. 105). Also, PFI Sdn Bhd may opt to issue bonds with 5 per cent to 6 per cent returns to obtain funding (Jayaseelan & Tan, 2006, pp. 99). Jayaseelan and Tan (2006, pp. 99) mentioned that the EPF has the option to possess some of the assets subsequent to construction and maintenance as partial repayment of the loan from PFI Sdn Bhd and PFI Sdn Bhd could allot the lease payments to the EPF. While the EPF releases some of the burden of project financing (as local financing bodies are reluctant and sceptical of a PPP) it creates another issue which is

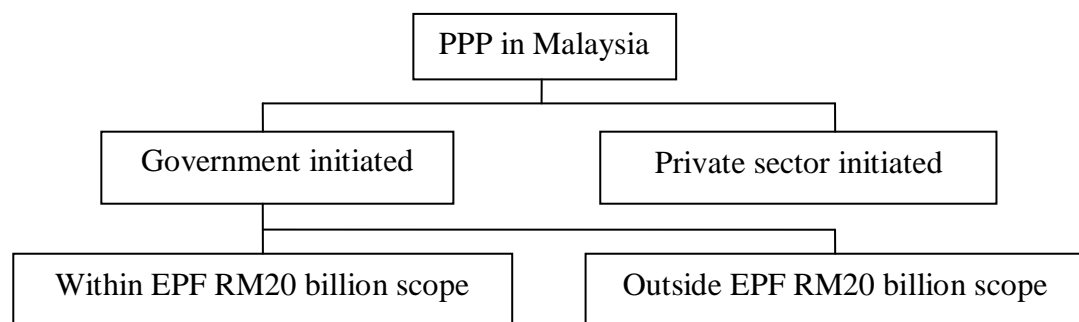
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<sup>31</sup> Sdn Bhd is abbreviated from Sendirian Berhad, indicating a private limited company in which the liabilities of its members are limited to the respective amount of shares that they own (Business Entities..., 2010).



inconsistent with a normal PPP arrangement in which private sector partners are supposed to bear most or all of the project costs. The EPF provided RM20 billion for selected PFI under the 9MP (Jayaseelan & Tan, 2006, pp. 96). According to Jayaseelan and Tan (2006, p. 96) RM9.5 billion was allocated for education, RM1.6 billion for housing, RM878 million for healthcare, and RM634 million for transport. Jayaseelan and Tan (2006, p. 96) added that there are *other projects exclusive of the RM20 billion* allocations. The government-initiated the Second Penang Bridge and private sector-initiated bullet train are examples of these other projects (Jayaseelan & Tan, 2006, pp. 96) which exemplify the more common form of PFI in which the private sector partner will be fully responsible for project funding. Therefore Figure 8 shows the difference in PPPs that are uniquely Malaysian.

**Figure 8 PPP in Malaysia**



(Source: Takim, Ismail, Nawawi & Jaafar, 2009, p. 105)

Figure 8 suggests that the allocated RM20 billion represents the minimum investment of PFI in Malaysia for the 9MP period. Following the RM20 billion fund, the GoM encourages the PFI-interested private entities to bid for the limited funding assistance. The conditions are (Abdul Razak, 2009, March 10):

1. The private sector will implement, finance and assume project risks. The project's revenue must be generated principally from the private sector, and not from Government sources;
2. Government financial assistance will only constitute a small proportion of the project investment cost to enable a marginally non-viable project to become viable; and
3. Projects to be implemented must be in strategic sectors, such as education, health and tourism; have high spill over effects; create sustainable job opportunities; and enhance the nation's competitiveness.

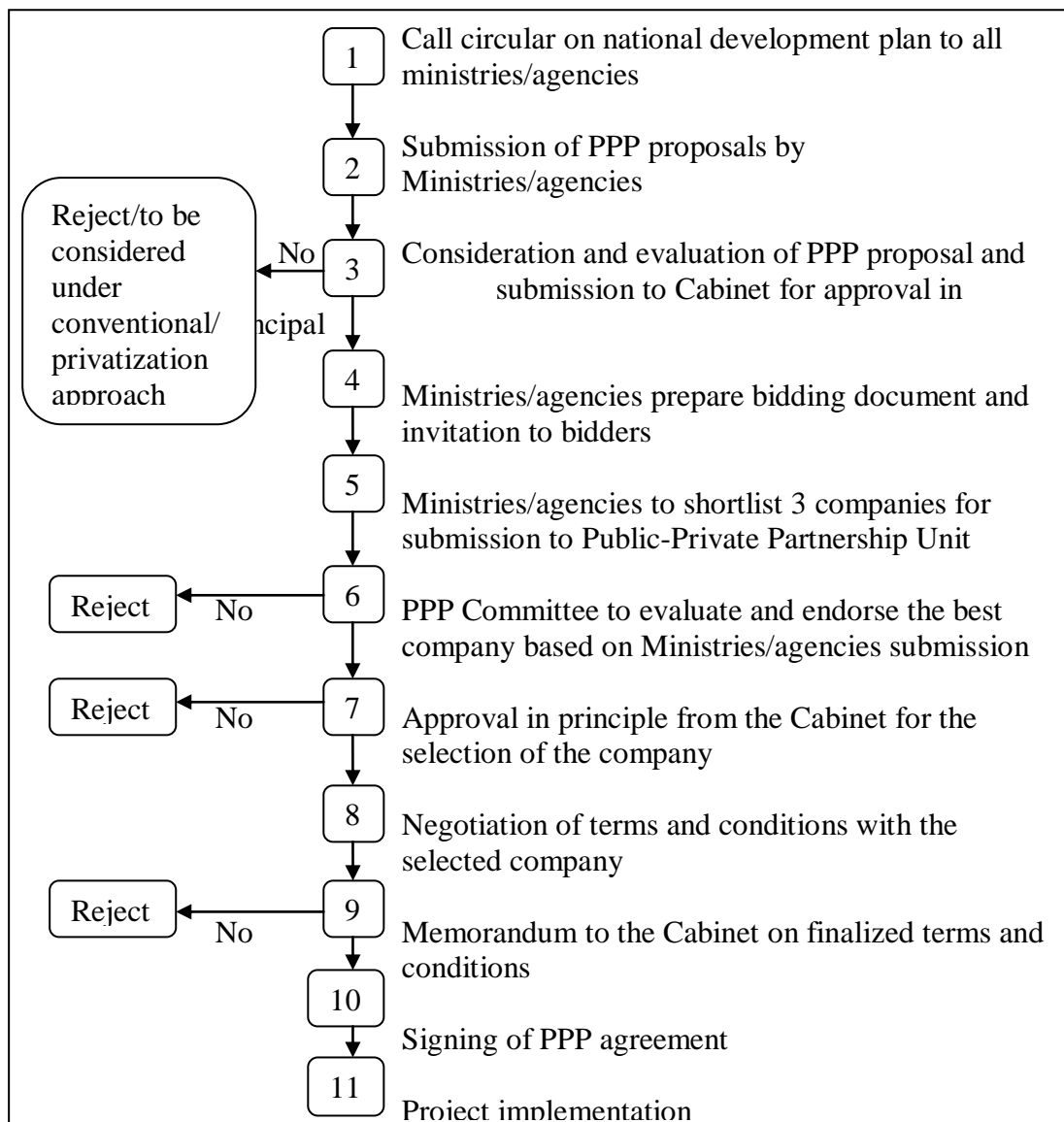
Although the fund would encourage private sector entities to participate in PFI projects, it also worries many who believe that it will undermine PFI, regardless of the amount allotted to facilitate PFI. They argue that funding should come from the private sector partners, just as the name suggests, private finance initiatives. Although the GoM believes that the project would be promising, it needs to be attentive of a self-fulfilling prophecy among the general public which could devastate efforts for PFI. The criticisms on the PFI facilitation fund will be further discussed later.

A periodic payment, also known as the Unitary Charge (UC) is another important PPP feature. Most PPP arrangements are expected to have this feature included as it motivates the private sector partners to perform as specified. The GoM clarifies it as (Ahmad Badawi, 2009, p. 1):

1. made up of capital and service payments;
2. payable when the asset becomes functional until the contract end; and
3. deductible based on the formula in the contractual payment mechanism with failure to deliver specified output and performance as contracted).

Ahmad Badawi (2009, p. 2) further explained that the contract price (both capital and service elements) is fixed, which can benefit the government because the private sector will have to bear any variation to the construction and maintenance costs. If any cost variation did occur, to an extent that could affect performance based payments, the private sector partner might adversely react to the effect. This possibility warrants for a transparent government and reputable private sector partners for a successful PPP.

Figure 9 summarizes PPP project selection (3PU, 2009, p. 11):

**Figure 9 The process flow of a PPP**

### 3.3. Summary

So far, in both countries, it is apparent that pursuing PPPs involve long and meticulous stages intended to ensure a PPP is necessary in light of rationality and transaction costs. The striking difference in PPP features in both countries is the project finance aid for PFI in Malaysia. This practice differentiates Malaysia's PFI from other PFI versions and from the lack of public discussion in New Zealand about financing options. Malaysia's financing arrangements are different from other countries where most PPPs are successful partly because the private sector partner is solely responsible for project finance to motivate it to perform well. However, it has been made clear that the Malaysian finance market is sceptical of PPPs, justifying the need for financial aid. In this way, Malaysia has

found a way to get around the small market that has so far contributed to the restriction on PPPs in New Zealand. However, it requires the government to inject public funding into the PFIs which reduces the benefits of the private partnership. Both countries justify the need for PPP in delivering any projects that the governments could not deliver without involving the private sector while attracting potential partners from the private sector.

Apart from the features, the success of a PPP is also dependent on the allocation of risks.

## 4. Risk allocation

Risk allocation is an important feature in a PPP because it affects VFM and accounting for PPP. While chapter 3 introduced features that shape PPP framework, chapter 4 presents the risks that could inhibit the success of a PPP.

Risks are defined as *any factor, event or influence that threatens the successful completion of a project in terms of time, costs or quality* (Medda, 2007, p. 214). Medda (2007, p. 214) provides examples of the main risks affecting a PPP in transportation which are technical, commercial, political and regulatory, and economic and financial risks<sup>32</sup>. In a PPP, risks are not only identified but also shared between partners based on the knowledge that organizations have different problem-solving abilities. Poor allocation of risks will negatively affect the progression of a PPP. Hence, a designated risk bearer must be the entity best able to influence and control the outcome cost-effectively (Medda, 2007, p. 214). A PPP in Papua New Guinea is an example (Asian Development Bank, 2008, p. 2):

*...a BOT [build-operate-transfer] contract for the supply of electricity was structured without considering potential currency risks. Thus, when the national currency devalued against the US dollar, the spread between the cost of purchasing power from the BOT partner (in US dollar) and the revenue from consumer payments (in local currency) widened substantially to the detriment of the public sector purchaser.*

Even if all risks are considered, allocation of risk has not always been appropriate, and the government has had to assume risks that were initially transferred to the private party (Webb & Pulle, 2002). This is as happened to the Sydney airport rail link, which the NSW Government took over after the company that built and operated the link failed to meet scheduled payments to creditors (Webb & Pulle, 2002). Transaction cost economics (TCE) may suggest that these risks arise from uncertainty due to bounded rationality and

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<sup>32</sup> Medda (2007, p. 214) explains the following as the main risks in a PPP transport:

1. technical risks: risks in construction;
2. commercial risks: uncertainty in marketplace;
3. political and regulatory risks: government actions affecting private sector profitability; and
4. economic and financial risks: uncertainties concerning economic growth, inflation rates, convertibility of currencies, and exchange rates.

opportunism. Detailed research on the impact of TCE on failed PPPs might be able to provide deeper insights into how exactly TCE and failed PPPs are related as well as how successful PPPs strive against the problems brought up by TCE. This is beyond the scope of this thesis, but research into the relationship between TCE and PPPs could identify critical factors that inhibit PPP successes.

The contingency theory could also explain the issues of allocation of risks from theoretical angle. It identifies specific aspects associated with certain defined circumstances and demonstrates an appropriate matching (Otley, 1980, p. 413). This match is known as *fit* and according to Betts (n.d., p. 123) *the better the fit the higher the performance* which indicates *a match between the characteristics of the environment and those of the organization*. In a PPP, these characteristics are taken into consideration and matched to the best partner for a fitting allocation of risk. Each identified risk is matched to most fitting partners for better PPP progression.

Further, the theory identifies that *there is no one best way to organize and any way of organizing is not equally effective* (Betts, n.d., pp. 123). Since different environments lead to different internal and external constraints to be considered in each setting, it is comprehensible that each PPP agreement will have different contractual terms depending on the nature of the asset or service.

The theory also distinguishes mechanistic (*a stable environment and routine technology*) from organic (*an unstable or turbulent environment and changing technology*) forms of organization and management (Betts, n.d., p. 124). Donaldson (2001, p. 47 & p. 58) added that a mechanistic structure emphasizes hierarchy and fits an environment with low uncertainty, low rate of market, low technological change, short-term orientation, and with employees who were comfortable being controlled, liked to work with others, and had low tolerance for ambiguity. He then explains that organic structures emphasize participation and fit an environment with high uncertainty, high rate of market, high technological change, long-term time orientation, and with employees who prefer autonomy and have high tolerance for ambiguity. This way the organization and its personnel can better respond to the constantly changing technology. Deductively, a PPP arrangement should be of organic forms to cater for the possibility of renegotiation arising from uncertainties that are unavoidable with long term contracting.

Donaldson (2001, p. 58) further adds that *a major source of task uncertainty is innovation, much of which comes ultimately from the environment of the organization, such as technological and market change*. Innovation as a major source of task uncertainty may be applicable to a PPP as one reason for PPPs (as noted in Chapters 1 and 3) is the way that private partners can innovate. For this chapter, the highest performance would refer to strategic risk allocation that minimizes the magnitude of each allocated risks so that rational choice theory prevails. This thesis does not go deeper into this issue, but research into PPP from the viewpoint of contingency theory could contribute to knowledge about PPP development.

In relation to risk factors, Ng and Loosemore (2007, p. 70) believe that risks should also be given to those who want and can take on the risks. The risk-taker could charge a premium for accepting risk. Willingness and ability to take on risks should be able to minimize risk exposure. This relates back to both contingency theory and transaction cost theory, as an attempt to create a proper matching (a match between the environment and ability of the risk-takers and the risk itself).

It is expected that there will be common risks identified across countries. However, the treatment of the identified risks could differ across projects and nations. Further, since risks are shared with the public sector, the severity of some risks may be alleviated. While this chapter recognises different risks to assess whether these impact the take-up of PPPs in New Zealand and Malaysia, future research might want to work on identifying these treatments of different risks across projects and nations in order to understand how PPP-related authorities decipher the match that would work in favour of a successful PPP.

Generally, there are two main groups of risks (Ng and Loosemore, 2007, p. 69). The first is general risks which are not directly associated with project strategies, but can affect the outcome. The second is project risks that originate from project management or from events in its immediate microenvironment. Figure 10 explains specific risks arising from a typical construction project according to type, source and likely bearer.

**Figure 10 Risks identification and allocation (Source: Ng & Loosemore, 2007, p. 70)**

| Type of risk                         | Source of risk  | Risk taken by   |
|--------------------------------------|---|---|
| <b>1. Site risks</b>                 |   |   |
| Site conditions                      | <ul style="list-style-type: none"> <li>• Ground conditions, supporting structures</li> </ul>  | <ul style="list-style-type: none"> <li>• Construction contractor</li> </ul>   |
| Site preparation                     | <ul style="list-style-type: none"> <li>• Site redemption, tenure, pollution/discharge, obtaining permits, community liaison</li> <li>• Pre-existing liability</li> </ul>  | <ul style="list-style-type: none"> <li>• Operating company/project company</li> </ul>                                   |
| Land use                             | <ul style="list-style-type: none"> <li>• Native title, cultural heritage</li> </ul>   | <ul style="list-style-type: none"> <li>• Government</li> </ul>  |
| <b>2. Technical risks</b>            |   |   |
|                                      | <ul style="list-style-type: none"> <li>• Fault in tender specifications</li> <li>• Contractor design fault</li> </ul>   | <ul style="list-style-type: none"> <li>• Government</li> <li>• Design contractor</li> </ul>                             |
| <b>3. Construction risks</b>         |   |   |
| Cost overrun                         | <ul style="list-style-type: none"> <li>• Inefficient work practices and wastage of materials</li> <li>• Changes in law, delays in approval, etc.</li> </ul>   | <ul style="list-style-type: none"> <li>• Construction contractor</li> <li>• Project company/investors</li> </ul>        |
| Delay in completion                  | <ul style="list-style-type: none"> <li>• Lack of coordination of contractors, Failure to obtain standard planning approvals</li> <li>• Insured force majeure events</li> </ul>  | <ul style="list-style-type: none"> <li>• Construction contractor</li> <li>• Insurer</li> </ul>                          |
| Failure to meet performance criteria | <ul style="list-style-type: none"> <li>• Quality shortfall/defects in construction/commissioning tests failure</li> </ul>   | <ul style="list-style-type: none"> <li>• Construction contractor/project company</li> </ul>                             |
| <b>4. Operating risks</b>            |   |   |
| Operating cost overrun               | <ul style="list-style-type: none"> <li>• Project company request or change in practice</li> <li>• Industrial relations, repairs occupational health and safety, maintenance, other costs</li> <li>• Government change to output specifications</li> </ul> | <ul style="list-style-type: none"> <li>• Project company/investors</li> <li>• Operator</li> <li>• Government</li> </ul> |
| Delays or interruption in            | <ul style="list-style-type: none"> <li>• Operator fault</li> <li>• Government delays in granting or</li> </ul>  | <ul style="list-style-type: none"> <li>• Operator</li> <li>• Government</li> </ul>                                      |



|                                       |   |  |
|---------------------------------------|---|--|
| operation                             | renewing approvals providing contracted inputs  |  |
| Shortfall in service quality          | <ul style="list-style-type: none"> <li>• Operator fault</li> <li>• Project company fault</li> </ul>   | <ul style="list-style-type: none"> <li>• Operator</li> <li>• Project company/investors</li> </ul>  |
| <b>5. Revenue risks</b>               |   |  |
| Increase in input prices              | <ul style="list-style-type: none"> <li>• Contractual violations by government-owned support network</li> <li>• Contractual violations by private supplier</li> <li>• Other</li> </ul>       | <ul style="list-style-type: none"> <li>• Government</li> <li>• Private supplier</li> <li>• Project company/investors</li> </ul>                      |
| Changes in taxes, tariffs             | <ul style="list-style-type: none"> <li>• Fall in revenue</li> </ul>   | <ul style="list-style-type: none"> <li>• Project company/investors</li> </ul>  |
| Output demand                         | <ul style="list-style-type: none"> <li>• Decreased demand</li> </ul>  | <ul style="list-style-type: none"> <li>• Project company/investors</li> </ul>  |
| <b>6. Financial risks</b>             |   |  |
| Interest rates                        | <ul style="list-style-type: none"> <li>• Fluctuations with insufficient hedging</li> </ul>  | <ul style="list-style-type: none"> <li>• Project company/government</li> </ul>   |
| Inflation                             | <ul style="list-style-type: none"> <li>• Payments eroded by inflation</li> </ul>  | <ul style="list-style-type: none"> <li>• Project company/government</li> </ul>   |
| Force majeure risk                    | <ul style="list-style-type: none"> <li>• Floods, earthquakes, riots, strikes</li> </ul>   | <ul style="list-style-type: none"> <li>• Shared</li> </ul>   |
| <b>7. Regulatory/ political risks</b> |   |  |
| Changes in law                        | <ul style="list-style-type: none"> <li>• Construction period</li> <li>• Operating period</li> </ul>   | <ul style="list-style-type: none"> <li>• Construction contractor</li> <li>• Project company, with government compensation as per contract</li> </ul> |
| Political interference                | <ul style="list-style-type: none"> <li>• Breach/cancellation of licence</li> <li>• Expropriation</li> <li>• Failure to renew approvals discriminatory taxes, import restrictions</li> </ul> | <ul style="list-style-type: none"> <li>• Government</li> <li>• Insurer, project company/investor</li> <li>• Government</li> </ul>                    |
| <b>8. Project default risks</b>       | <ul style="list-style-type: none"> <li>• Combination of risks</li> </ul>  | <ul style="list-style-type: none"> <li>• Equity investors followed by banks, bondholders and</li> </ul>  |

|                       |  |   |
|-----------------------|--|---|
|                       | <ul style="list-style-type: none"> <li>• Sponsor suitability risk</li> </ul>   | institutional lenders<br><ul style="list-style-type: none"> <li>• Government</li> </ul>   |
| <b>9. Asset risks</b> | <ul style="list-style-type: none"> <li>• Technical obsolescence</li> <li>• Termination</li> <li>• Residual transfer value</li> </ul> | <ul style="list-style-type: none"> <li>• Project company</li> <li>• Project company/operator</li> <li>• Government, with compensation for maintenance obligation</li> </ul> |

Although risks' names and the degree of focus on the risks may contractually differ, risks in a PPP project are expected to not be that different from any other construction project except for the possible alleviation of some risks' severity caused by having a public sector procurer as a partner. In particular, Grimsey and Lewis specifically pointed that there are six areas of risks associated with PPPs (Ng and Loosemore, 2007, p. 70):

1. public risk: government's duty to ensure successful delivery of facilities;
2. asset risk: assets are of shorter lives than anticipated, maintenance costs are more than anticipated, assets damaged or destroyed by a force majeure event, etc;
3. operating risk: purchased services not delivered as agreed in terms of specification, costs or timing;
4. sponsor risk: a SPV is unable to meet its contractual obligations and the government is unable to enforce them or recover compensation;
5. financial risk: prices and costs increases, financiers withdrawing, interest rates increasing or from poorly designed financial structures; and
6. default risk: unable to perform contractual obligations on time or to defined standards.

These six risks will be compared to risks identified in New Zealand and Malaysia. The main problem in allocating risks lies in allocating the risks to the right partner and ensuring that the risks transferred are truly transferred. Allocating these risks to the partner that can handle them cost- and time-effectively may seem straightforward. However, identifying, classifying and allocating risks are not simple tasks as these tasks involve uncertainties and judgments which result could be either desirable or disastrous giving rise to risk disputes. Hence, disputing over risk allocation is not unprecedented. For this matter, Medda (2007, p. 215) suggested arbitration, mediation, mini-trial, private judging, neutral expert fact finding, and final offer arbitration as optional in resolving disputes to avoid court litigation and contracts renegotiation. Medda (2007, p. 217) looked at risk allocation using the final

offer arbitration game and found that a settlement rather than an arbitration agreement may reduce the effects of potential moral hazard problems where guarantees have higher value than the financial loss related to the risk covered by the guarantees. This means that a chosen dispute resolution must also take into account potential moral hazard problems to ensure the right partner is bearing the right risks.

Also, it is important to minimize errors in allocating risks. This is because effective risk allocation will have positive effects on VFM achievement (English, 2005, p. 93). Also, allocation of risks will influence economic ownership of the asset which depends on who bears the risks and benefits of ownership (English, 2005, p. 103). This will in turn affect off-balance sheet accounting treatment which will only be available to the public sector partner if the economic ownership of the asset lies with the private sector partner. The failed Latrobe Regional Hospital PPP in Australia provides empirical evidence and insights into the difficulties facing PPP partners in identifying and allocating risk in PPP arrangements (English, 2005, p. 111). According to English (2005, p. 109), Latrobe Regional Hospital's failure was induced by unreasonable assumptions about government subsidies and costs; misunderstanding of the hospital casemix-funding model and its impact on future levels of funding; and an assumption by the PPP operator of the government's willingness to renegotiate the contract (English, 2005, p. 109). In this example, the operator was not only unable to make a profit from contracted payment levels for the delivery of the services (English, 2005, p. 109), but also misunderstood the casemix-funding model, and expected renegotiation, which the government declined (English, 2005, p. 112). In this particular example, both parties are responsible for the failure. Risk was inappropriately borne. Government accepted the lowest bid without considering sponsor risk or political risk and appeared to expect the private sector to deliver identical services more efficiently than it could. English (2005, p. 112) suggests this may have clouded government's judgement. This demonstrates the importance of meticulously identifying and allocating risks to the right partner, but also of the delicate balance that this requires. The lack of a 'crystal ball' (i.e. bounded rationality and uncertainty) to see all future risks is also an issue.

## 4.1. Risk allocation - New Zealand

The OAG (2006, p. 8) also emphasizes identifying and allocating risks wisely for VFM achievability. Despite the problem of bounded rationality, risks should be well identified to ensure that vital risks are dealt with. The Waterview Connection<sup>33</sup> steering group identified and reported the following risks (Report of the Waterview Connection Steering Group, 2008, p. 25):

**Figure 11 Risks as identified by the Steering Group**

| Risk category                                   | Description  |
|---|--|
| 1. Site risk                                    | Risks such as the availability of the site and planning and consenting risks.  |
| 2. Design, construction and commissioning risks | Risks such as ensuring the design is fit for purpose, unforeseen ground conditions, and construction cost escalation.  |
| 3. Operating risks                              | Risks such as higher than expected operating costs, the risk that refinancing increases or decreases the cost of borrowing.  |
| 4. Demand risk                                  | The risk that traffic demand is more or less than anticipated.   |
| 5. Market risks                                 | Risks such as market competition, availability of finance and inflation.   |
| 6. Policy change risk                           | The risk of general policy changes that affect the profitability of the PPP as well as specific changes that have a material adverse effect on the private sector partner. |
| 7. Force majeure risk                           | Inclusive of uninsurable risks such as war and terrorism.  |

Public sector partners are responsible for risks that are required by legislation to remain with the public sector partner and also the risks that they directly control. These risks are inclusive of (Report of the Waterview Connection Steering Group, 2008, p. 25):

1. Obtaining a designation and resource consents;
2. The development and approval of any tolling scheme;

<sup>33</sup> For details on Waterview Connection, refer to <http://www.nzta.govt.nz/projects/waterviewconnection>.

3. Land purchase; and
4. Discriminatory law change directed specifically at the PPP

Another risk that a government should be careful of is reputational risk and this risk relates to project commitment. Although the government can withdraw before contract sign up, withdrawal for reasons other than VFM could harm New Zealand's and the NZG's reputation as this could reduce the number of bidders and the costs of the project in subsequent attempts to pursue a PPP (NIU, 2009, p. 13-14). This could mean that the quality of infrastructure built may suffer since the competition between fewer bidders may not be able to pressure competitors with high expertise to bid on higher quality construction and maintenance. Consequently, PSC might show that a project would be better off without a PPP.

Comparing this list to the previous six identified risks associated with PPPs, it seems apparent that there are key risks for a PPP that are missing, namely public risk, asset risk, sponsor risk, financial risk and default risk. As shown in the previous examples, these risks are essential and should be identified and allocated appropriately so that the responsible partner would be able to react to risk exposure. However, the Report of the Waterview Connection Steering Group has identified other risks that are not listed in the essential six risks for a PPP. This either shows that the missing risks are incorporated into the additional risks or the missing risks are deemed less important than the missing risks. Had there been a misjudgement in identifying risks, this could have a detrimental affect on the PPP success.

New Zealand has already identified risks that should be borne by the public sector partner. Some risks must stay with the public sector either because they fall within the public sector partner's responsibility or because it has been constituted that way to protect public interest. Similar to English (2005), these include the need for government to deliver public services even when the private operator fails. As for the other risks, they are normally transferred wholly or partly to the private sector partner. Since the practice of risk allocation is susceptible to its environment, such as the type of project, the procurer's background and resources availability, there might be practices in which both partners share a particularly challenging risk either equitably or as deemed appropriate. Hence, the risk sharing practice in New Zealand is unclear due to a lack of projects, future research might want to analyse future projects and risk development.

Risk also affects finance. Fletcher<sup>34</sup> however, questioned whether private sector funding would be viable in the current credit environment without government guarantees, whilst realizing that guarantees would nullify the transfer of risk to the private sector (Gibson, 2008). This occurred in Australia (English 2005) and Gibson (2008) calls PPP risk transfer illusory<sup>35</sup>. The Press (2008) reported that if a PPP project did not provide revenues for the private sector partners, taxpayers will have to bail them out which means that financial risk eventually stays with the taxpayers even though the risk should have been transferred to the private sector partners. Following this, chief executive of Fletcher Building's infrastructure division, Mark Binns suggested that if the transfer of risk was incomplete, arguably, the Government would be better off raising debt, potentially through infrastructure bonds, using other traditional procurement methods (Gibson, 2008).

Incomplete risks transfer might be the reason for illusory benefits of risks transfers. The practice of identifying and allocating risks is not immune to human errors because there are judgements involved. Hence, the chosen method to identify and allocate risks should support complete and effective risk transfer but the involvement of public goods does make this difficult.

## 4.2. Risk allocation – Malaysia

A PPP generally transfers from the government to the private sector partner(s) *the responsibility to finance and manage a package of capital investment and services including the construction, management, maintenance, refurbishment and replacement of public sector assets such as buildings, infrastructure, equipment and other facilities, which creates a standalone business* (3PU, 2009, p. 4). The transfer of these risks to the private sector indicates the perception that the private sector partners are better than their counter-partner at handling and managing the risks at the least costs. Had the public sector assumed the responsibility for these risks, it is assumed that the end result would be substandard, thus the time and public fund spent would have been wasted. As warned before, this perception should not cloud rational and cautious judgement in managing risks.

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<sup>34</sup> The Fletcher Construction Company is a general contractor in New Zealand and the South Pacific [www.fletcherconstruction.co.nz].

<sup>35</sup> The British Government's bailout of Metronet, the private operator of the London Underground (Gibson, 2008)

Norton Rose (2006, p. 4) conducted research in Asia and presented the following risks:

**Figure 12 Risks as identified by Norton Rose**

| <b>Risk categories</b>    | <b>Description</b>   |
|---------------------------|--|
| Supply risk               | Certainty of supply of goods and materials. Quality of supply, ease of importation of goods, transparent tax regime.   |
| Demand risk               | Demand for infrastructure linked to payment<br>Is patronage a major risk?  |
| Completion risk           | Ability to reach financial close and ability to satisfy conditions precedent including land acquisition, construction and commissioning the project on time and on budget.                           |
| Operational risk          | Skill and experience of operator. Quality of supply of spare parts and materials, energy supply and labour.  |
| Environmental risk        | Compliance with environmental law: comprehensive impact studies and viable means of mitigating contamination.  |
| Engineering risk          | Complexity of the project and availability of skilled labour, contractors and professionals. Largely mitigated by expertise but can be affected by ground condition, flooding, seismic activity etc. |
| Political risk            | Political violence/terrorism, risk of expropriation and currency convertibility.   |
| Counterparty risk         | Quality of counterparties, governments or other 'offtakers' (credit risk assessment). Reliability of contractors and government licence/permitting departments.                                      |
| Legal and regulatory risk | Sanctity of contracts, legal transparency, lack of corruption, clear regulation and enforcement of laws.   |
| Foreign exchange risk     | Restrictions on currency exchange, currency exchange fluctuations, currency remittance laws/restrictions on borrowing, depth of swap markets.  |

From these identified risks, the report shows that (Norton Rose, 2006, p. 8):

1. Demand risk is the main concern of respondents across countries and sectors;
2. Demand risk should be allocated to governments;
3. Too many projects across the region either do not meet the transport needs of the public thus under-utilized or cost too much to be of practical use;

4. Governments will need to subsidize many projects to alleviate demand risk concerns and public funds will need to be well allocated; and
5. Sponsors could be induced to deliver future costs savings through the use of PPP output specifications and payment mechanisms which Asian governments have not yet embraced.

Norton Rose explained that demand and completion are reported as the biggest concerns because most of the respondents were bankers who cared more for projects' vulnerability to bad economics and delay (Norton Rose, 2006, p. 11). The report also mentioned that the rationale behind the completion risk being one of the biggest concerns is postponement of delivery of land or permits by the government (Norton Rose, 2006, p. 11). It might be fair to state that, from the standpoint of the loan providers, the demand and completion risk are the most important as there are cases of incomplete projects resulting in huge financial loss. The survey suggested that funding availability requires mitigation of demand and completion risks, and the sponsors to be connected with reliable counterparties (government and contractors), especially in countries with liquid domestic financing like China, Thailand, Malaysia and Singapore (Norton Rose, 2006, p. 11).

In comparing the mentioned risks with the six risks earlier, other than operating risk, the remaining five risks are missing. Similar to New Zealand, only operating risks are properly identified. However, as mentioned before, the missing risks could have simply been named differently or merged or separated into different risks, such as financial risks in comparison to foreign exchange risks and sponsor risk in comparison to counterparty risk.

With regards to the financing through the EPF fund aid, in which GoM through EPF granted RM20 billion to PFI Sdn Bhd for 2006-2010, Gunasegaram (2006, pp. 100) argued that PFI Sdn Bhd and EPF are exposing GoM directly to construction risk, resulting in a contingent liability of up to RM20 billion. This is worrying because this implies that the construction and investment risk will basically remain with the government via PFI Sdn Bhd and not be transferred to the private contractors (Netto, 2006). Due to the future uncertainties and the possibility of massive compensation by the GoM to exit PFI if needed, Gunasegaram deemed it a misnomer to name such an arrangement a PFI (Gunasegaram, 2006, pp. 100). This concern is not only applicable to EPF's PPPs but also non-EPF's PPPs. Considering PPP projects are selected projects that are deemed important for nation development, it is highly likely that the government will have to step in if the projects



showed any signs of failure. Because of this possibility, choosing the right partners is vital because risk is not transferred.

According to Kiggundu, PPP is still unutilized in developing public transport in Kuala Lumpur. Considering that the normal practice in Kuala Lumpur is to transfer investment risk to the private sector, transferring the whole financing risk to the private sector partner is argued as reckless because most transport infrastructure projects are capital-intensive and fare revenues are rarely high enough for the private partner to achieve break-even. Because of this, Kuala Lumpur state has been separately financing and implementing its own public transport projects and programs except for some toll expressway projects for which the Federal Government has paid compensation and provided profit protection schemes for concessionaires (Kiggundu, 2009, p. 292-293). Macroeconomic stability such as inflation, foreign exchange, currency depreciation and fiscal policy can only be handled by the government as it formulates and implements policies (Kiggundu, 2009, p. 283). The partnerships between the private sector and the government are expected to solve the financing and investment risks associated with private concession agreement as experienced by Kuala Lumpur, Manila and Bangkok (Kiggundu, 2009, p. 283) but not a number of other risks listed in Figure 12. If the partnership manages to identify and allocate risks strategically, the partnership could (Kiggundu, 2009, p. 292-293):

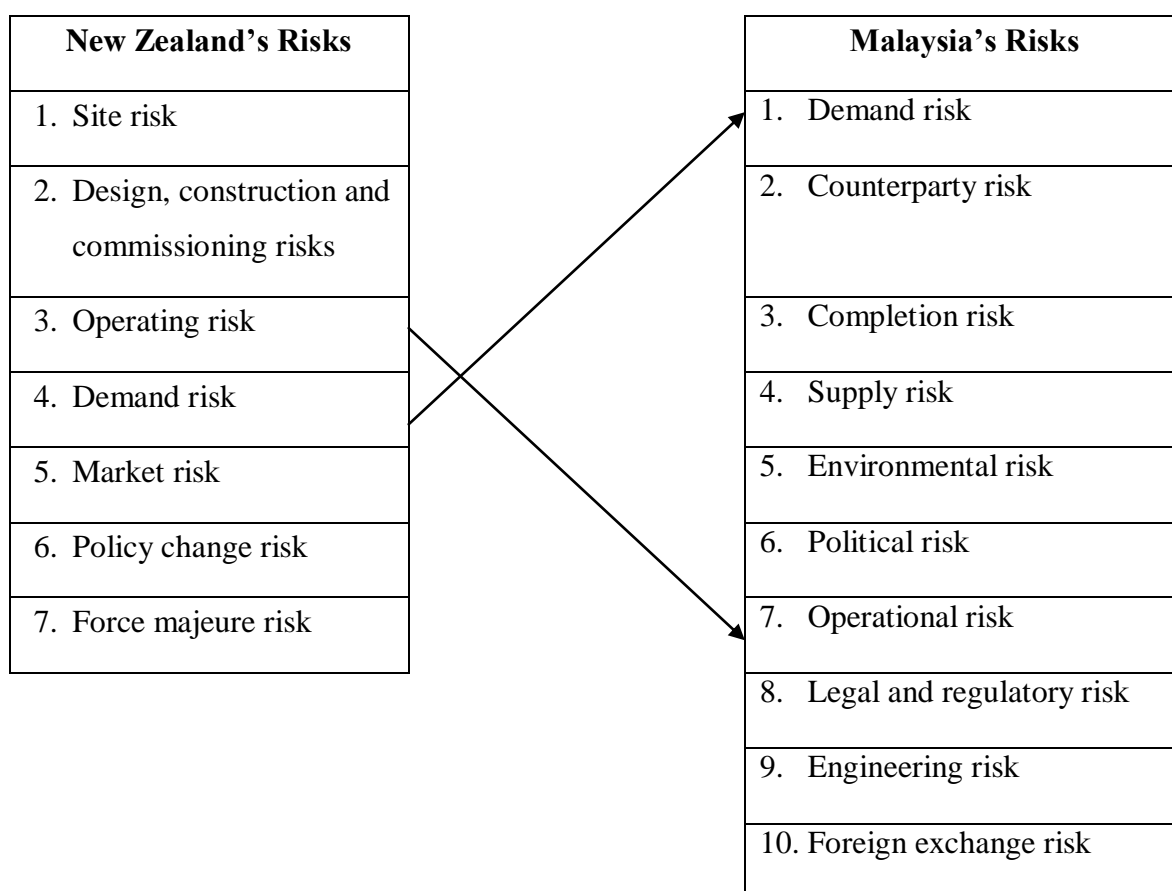
1. maximize the efficiency of the private sector in supplying public transport services in Kuala Lumpur;
2. assist policy makers to mitigate both commercial and non-commercial risks associated with the implementation of transport infrastructure projects;
3. make the public sector responsible for the relocation of the displaced people by the projects, land acquisition matters, the provision of soft loans especially to private bus companies and the provision of tax reductions and exemptions for public transport firms; and
4. require the State to subsidize interest payments of the loans secured by the public transport operators to build the new infrastructure.

So, the partnership will not only be responsible for the project development, but also other people affected by the project development. This concept is similar to corporate social responsibility and having a public official on board might be able to give a better sense relief to the people affected by the projects.

### 4.3. Summary

Another look at the presented risks in New Zealand and Malaysia shows that there are common risks across countries, although some may have been named differently. What makes them really different is the degree of regard that they have over particular risks as well as the partner assigned to effectively manage the allocated risks. These lists (Figure 10, Figure 11 and Figure 12) themselves represent the PPP environment and hindrances that could ultimately challenge PPP success.

**Figure 13 Comparing risks identified in New Zealand and Malaysia**



Comparing the two countries' risks and PPP's six areas of risks, there does not appear to be outstanding differences between them, other than different classifications, potentially suggesting differences in focus for each risk. This is as explained before by contingency theory that *any way of organizing is not equally effective*. Although different environments identified similar risks, these risks are not treated equally across country. As seen from the two lists, Malaysia identified more risks than New Zealand's. This could be indicative of experience or seriousness in pursuing a PPP. An alternative but less likely explanation is that the Malaysian environment has naturally more risks that could harm a PPP compared to New Zealand's. Other potential factors contributing to unequal treatment could be

government current policies, local and international financial market, general demand and political situation of respective country.

Claims of illusory risk transfer challenge the notion of real transfer of risks. According to Takim et al. (2009, p. 105), there is limited real risk transfer to the private sector since both counter parties to the contract are government entities which operate the project financing scheme. This refers to PPP projects where funding is aided by the EPF. However, there are other PPP projects that are not EPF-related. Plus, transferring risks require the ability to identify and quantify the risks monetarily to verify any effect from transferring risks. Otherwise, the perception of bogus risk transfer would lead to a self fulfilling theory among the general public that could hinder the government from pursuing PPPs. It is fair to expect standardization of similar risks in PPP countries after which comparison could have been possible across PPP countries to pinpoint the best practice of risk allocation. It may also be fair to add that the practice of sharing a particular risk between both sectors proportionately might emerge, although currently such a practice is still absent to protect the governments from all risks. However, the private sector could benefit from such a practice so that it will not have to expose itself to risks that it could limitedly take on. Acceptability of risks by the public sector depends on legislation and the public's approval. Thus, it has been highly advisable to utilize PPPs with the public's consent for better chances of success.

It is recognized however that total risk transfer will not occur when the asset or service is a public good, as government will be expected to deliver it. Thus public risk cannot be transferred. Further, the Malaysian government acts as financier and therefore takes on more risks than New Zealand seems prepared to take on. The EPF fund aid also reduces risk transfer in these PFI arrangements.

## 5. Performance indicators

Operators are compensated or rewarded based on performance. Therefore, indicators are needed to evaluate a project's progression and to work out compensations in a PPP project. This chapter will look at how performances are evaluated in New Zealand and Malaysia. Performance indicators and the required performance level are dependent on the project type (e.g. BOOT). Projects being delivered on time or earlier and within budget have been mainly used to indicate that the projects are doing well. However, the public is also curious about the progress of PPPs other than the physical development of contracted infrastructure, such as the contents of the contract agreement, the on-going number of users, and financial reports on each project especially when the public needs to pay for the infrastructure either directly or through taxes. This information may be restricted by commercial confidentiality of the private sector partner, or when the cost of publicizing the information outweighs any potential benefits. In response to this issue, a performance benchmark is set to mark project progression and/or success.

A typical PPP contract normally includes target benchmarks as key performance indicators (KPIs) in terms of acceptable ranges of performance rather than single-point measures of performance (OECD, 2008, p. 80). This is expected to sufficiently induce the private sector partners to perform well without de-motivating them. Additionally, specified performance levels should be output-specified rather than input-specified for innovation and optimal risk transfer. In the absence of appropriate comparators or benchmarks, an appointed government authority and the bidders will create a performance regime during the competitive stages of the procurement (HM Treasury, 2007, p. 69). This will allow them to devise reasonable<sup>36</sup> and objectively measurable performance levels. As examples, the UK and Australia employ efficiency measures (defined in terms of inputs and outputs), effectiveness measures (in terms of outcomes), service quality measures, financial performance measures, as well as process and activity measures (OECD, 2008, p. 81). Also,

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<sup>36</sup> A reasonable level is as decided by the Authority (HM Treasury, 2007, p. 69):

1. What the optimum 100% performance standard would be and whether it is achievable and essential (taking into account the nature of the Service), to set the required standard in the Contract at this level.
2. In some cases like operating theatres in hospitals and custody suites in police stations, the optimum; 100% standard is required and should be achievable. In other cases the Authority may recognize that the optimum 100% standard is neither always essential nor achievable. In such cases, the Authority may retain the optimum 100% level, but allow a certain leeway before the Contractor suffers for performing below such 100% level. For example, it may be acceptable for the Contractor to incur a certain number of performance points in any specified period before suffering financially where the Service provided is adequate without being excellent and the under-performance does not materially affect the operation in that area.

principal contractors and other private sector partners must submit their financial documents to the government<sup>37</sup> so that the financial performance of the concessionaire can be closely monitored by the government (OECD, 2008, p. 81). After concluding a PPP contract, the government assesses whether the contractor is actually delivering the contracted VFM and whether the financial and non-financial investment benefits of the project are delivered (OECD, 2008, p. 80). From these, it can be said that a PPP is constantly monitored and evaluated throughout its contracted period to minimize probability of project failure. Also the on-going evaluation allows both partners to be vigilant and responsive to matters that could adversely affect their project.

A performance benchmark for a PPP is represented by the public sector comparator (PSC) that measures the relative value for money (VFM) of a PPP contract (as noted previously in chapter 3). Performance of the PPP is monitored throughout its life and both partners will discuss the performance level after the PPP term has ended (OECD, 2008, p. 79-80). With regards to VFM, English Guthrie, Broadbent & Laughlin (2010, p. 73) suggest that VFM judgement must include contextually defined economy, efficiency and effectiveness concerns that incorporate contract fulfilment as well as current and future concerns for better informed decision-making. They also encourage performance audits to go *beyond a 'watchdog' to a 'sheepdog' role* for more active contribution to current and future projects instead of letting potentially crucial information remain silent. They added that *compliance with policy pronouncements and internal reviews are necessary but not sufficient to judge the economy, efficiency and effectiveness in a performance audit of the mature operational stage of private provision of public services* (English et al., 2010, p. 73). Hence, information gathered from compliance and reviews must be evaluated critically to identify relevant and reliable past events for future references.

## 5.1. Performance indicators - New Zealand

The Office of the Auditor General in New Zealand noted that performance measures and standards should be quantitative and qualitative (OAG, 2006, p. 43). Relying only on quantitative performance measurements could heighten the absence of key qualitative areas which can be catastrophic as happened with the Deer Park Women's Prison in Victoria. The prison is a failed build-own-operate project which performance measures were largely

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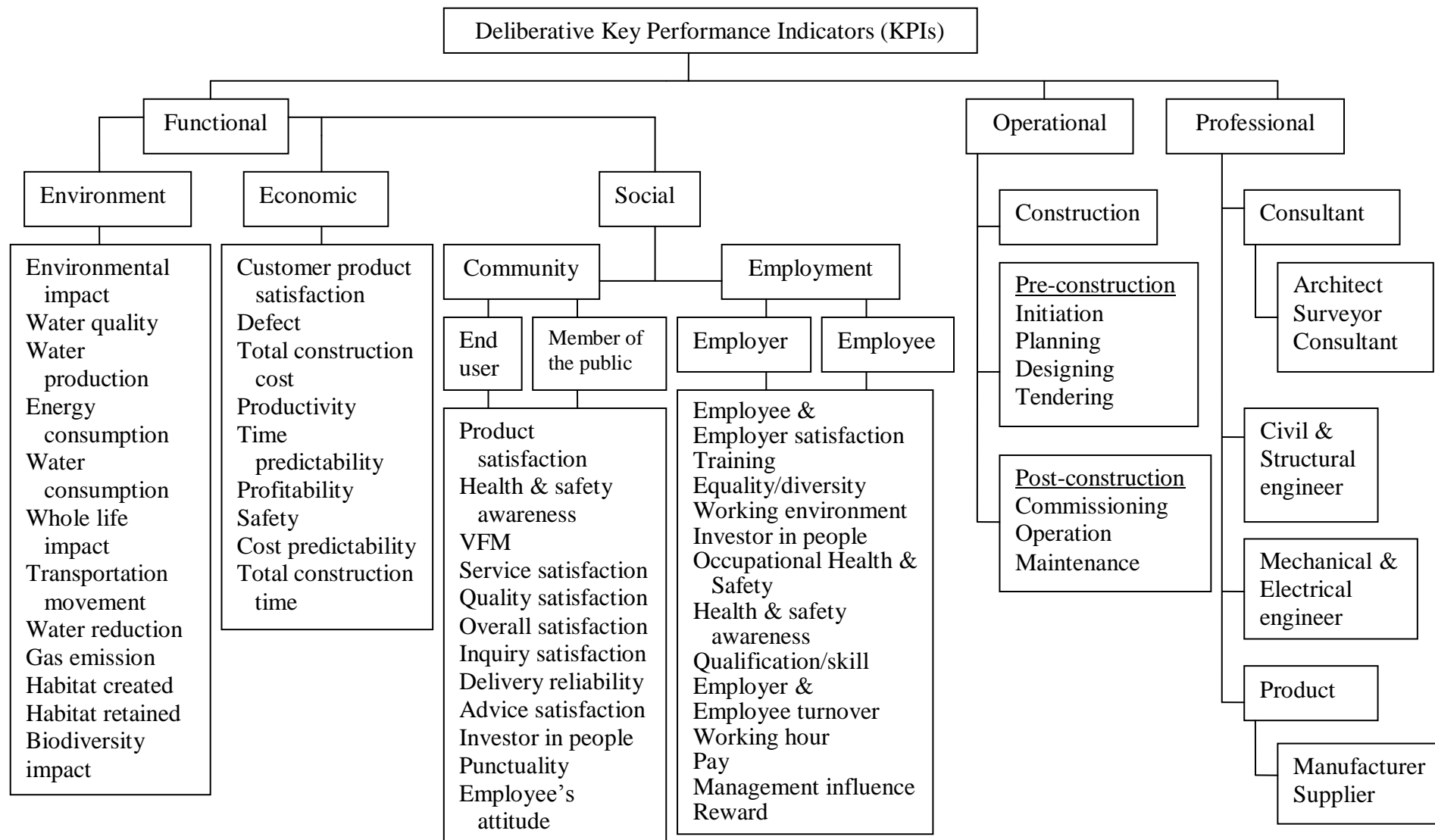
<sup>37</sup> However, contracts in Victoria normally exclude financial performance measures (OECD, 2008, p. 81)

quantitative. Thus there was too much focus on short-term achievements when the project is meant for a long term (OAG, 2006, p. 43). Hence in choosing KPIs, quantitative and qualitative measures should be employed in ways that objectively support a project's on-going evaluation. Performance measures and KPIs generally include safety, quality, customer service and/or incidents/accidents as well as price, asset management and asset development (Waterview Connection Steering Group, 2008, p. 20). Performance management is crucial and accordingly it should be part of the initial decision-making process in choosing the procurement method because performance monitoring systems should include responsibility specification and mechanisms to identify and manage poor performance (OAG, 2006, p. 67). Good performance management will positively affect the overall project and the operator's performance. Hence, the public sector partner should inspect its partners' performance reporting systems to ascertain truthful performance measurement and reporting, and to reassure its partners' financial viability (OAG, 2006, p. 43). Because of this, a contractor must provide independent reports as assurance over the reliability of the provided performance information (OAG, 2006, p. 44). Since 2002, for Wellington City Council's Clear Water project which is a design-build-maintain-operate (DBMO) sewage treatment plant, the Council has conducted more physical inspections and benchmarked the performances of the UK-based contractor (Removing barriers..., n.d., p. 3).

Together with the developed KPIs, there should be specific arrangements to deal with substandard performance or project failure, in which case, the public sector could exercise rights to intervene such as default provisions and step-in rights (OAG, 2006, p. 44). These arrangements function as a back up plan meant to keep the project going, considering that most PPP projects are critical projects for the general public. However, the National Audit Office in the UK found that the public sector partner had not demanded all the entitled information, which hampered the ability of the public sector partner to monitor the project's progression thus denying external financiers the opportunity to bring private sector financial disciplines to the project at an early stage (OAG, 2006, p. 44). This indicates that proper management planning must be followed by strict enforcement for strategies to take effect, unless deemed otherwise. Hence, not only must each partner comprehend their roles, but they need to also execute them.

## 5.2. Performance indicators - Malaysia

Similar to New Zealand, Malaysia also relies on KPIs. A private sector partner will receive sufficient lease charges as returns on investment that correspond with the level, quality and timeliness of service provision as assessed by designated KPIs (Ismail & Md. Yusof, 2009b, p. 78). These KPIs must be realistic, reliable and relevant because they affect service payments to the private sector partner, which in turn affects motivation to perform. If a KPI is unrealistic, it could have adverse effects on project participants' morale. Ismail and Md. Yusof (2009b, p. 78) mentioned that the difference between the concessions of the past and PFI is "the implementation process, not on the conceptual and philosophical of PFI". Whilst the past had been consumed by process, a PFI is output-driven, with more flexibility for the private sector partner to innovate in the process. Since KPIs allow both partners to reflect on the past, a chosen set of KPIs should be able to provide information that can assist present decision-making for future achievement. Accordingly, Ismail and Md. Yusof (2009a, p. 11) proposed the following (as shown in Figure 14) as Malaysia's Construction Key Performance Indicators (KPIs) for public infrastructure:



**Figure 14 Malaysia's Construction KPIs**



The KPIs suggested in Figure 14 are grouped into functional, operational and professional sources, each with their own sub-divisions, intending to include as much area as possible. Ismail and Md. Yusof (2009a, p. 8) explained that these are organized and characterized through careful and systematic discussion to allow for economic and social structure enhancement from the public infrastructure procurement approaches. They added that for greater public participation, public criticisms about PPPs are included in its formulation due to the significance of public needs and requirement. Participation of the curious general public is essential because as the end users, in some PPPs they are the source of revenue for the concessions, thus their willingness to pay for the services is partly a deciding factor on whether a PPP is a success or a failure. Based on the resulting KPIs, if the result is unfavourable, the GoM will not hesitate to penalize the responsible partners (Ismail & Md. Yusof, 2009a, p. 9). Even so, it should be remembered that KPIs are mere indicators of the past. Hence they should be referred to as on-going guidance instead of the ultimate goal.

The following represent the advantages of KPIs (Ismail & Md. Yusof, 2009a, p. 6-7):

1. benchmarks the organization performance against other industry or organization for targeted improvement;
2. highlights weaknesses;
3. alerts the directors and lower personnel;
4. focuses improvement efforts on critical issues;
5. encourages the industry players to utilize best practice and to maximize communication while avoiding the burden of brainstorming a list of good KPIs;
6. links employee rewards and sanctions to performance measured against the standard established to motivate individual performance;
7. improves the ongoing performances of the entire organization and project as KPIs score the performance, detect changed conditions, recognize potential problems and designate a change from preliminary strategy of particular project or organization; and
8. offers many perspectives on a single event where KPIs endorse intense focus and scrutiny, and compel improvement within the project or organization.

It is noted that these benefits are achieved with good KPIs. Otherwise, KPIs could lose some of their merits by missing out on the most important data for a particular project progression. Hence, KPIs must be developed in ways that will be most beneficial and relevant for both partners and other KPI users. Figure 15 shows the characteristics required of a good KPI (Ismail & Md. Yusof, 2009a, p. 8):

**Figure 15 Characteristics of MC KPIs**

| Characteristics  | MC KPIs |
|--|---------|
| 1. Consistently self-developed and timely available data | √       |
| 2. Continuously quantifiable and flexible valid data     | √       |
| 3. Easily understood data                                | √       |
| 4. Closely-monitor performance in reaching objectives    | √       |
| 5. Reflect and quantify intentional value drivers        | √       |
| 6. Value drivers establishment by member of the public   | √       |
| 7. Implemented throughout the project/business           | √       |
| 8. Graphically and visually illustrated e.g. chart       | √       |
| 9. Expression in number or non-number or both            | √       |
| 10. Distinguishable interpretation by different parties  | χ       |
| 11. Corporate standard measurement establishment         | √       |
| 12. Link with reward and penalty system                  | √       |
| 13. Improve performance and quality                      | √       |
| 14. All-in-one perspectives on a single event            | √       |
| Source: Ismail & Md. Yusof (2009a, p. 9)                 |         |

These characteristics represent information that KPI users deemed as important and crucial to a PPP project development.

### 5.3. Summary

Whilst the NZG emphasizes the whole performance management (including KPIs) throughout a PPP, Malaysia seems to be more concerned about the KPIs themselves. This shows that New Zealand has the capacity to discipline its private sector partner whilst Malaysia is more concerned about the data themselves. This is because privatization has different effects on both countries. As it has been boosting Malaysia's development, for New Zealand, it has induced prudence and a reticence in having private sector in public services<sup>38</sup>.

In performance measures that have been assessed, specific mention of economy, efficiency and effectiveness concerns are lacking. These areas were previously proposed by English et al. (2010) and it is surprising that they are not evident in either Malaysia or New Zealand. However, they could have been embedded in the KPIs. Since details on KPIs do not seem to be publicly available (potentially to protect a project from unwanted speculation) it is unclear as to whether these countries have similar or different appetite for PPP's KPIs. Thus, although each project's performances are well recorded or analysed, comparison with other projects locally and internationally can hardly be made. Without this comparison, it could not be determined if issues that emerged throughout project progressions were also affecting other local and/or international PPPs.

It has been made apparent by both countries, however, that KPIs are valued as performance indicators and performance motivators. This is because KPIs direct the partners to the problematic areas allowing them to alert the responsible partner which later allows them to identify the issues/factors giving rise to the problems. This will then allow them to revise whether the risks were allocated correctly. Future research should consider looking into KPI selection process and the consequences of the selection in order to better understand KPIs practicality as well as to enable comparison of best practice and similarity of standardized KPIs.

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<sup>38</sup> *With the National Party's decision not to move any state-owned enterprises to the private sector in its first term if elected this year, we appear to have a new political consensus between the major parties in New Zealand: privatisation is bad. ...The political aversion to privatisation is costing New Zealand potential gains in living standards* (Kerr, 2008).

## 6. Accounting for PPPs

Accounting for PPPs provides another form of performance indicator of PPPs. It identifies, measures, and communicates information for information users to make informed judgments and decisions (Grimsey & Lewis, 2002, p. 246). This chapter will present some of the issues relating to PPP-accounting. Naturally, accounting for PPPs should give a true and fair view of PPP transactions despite the uncertainty and risks from the absence of complete information about the past, the present and the future (Grimsey & Lewis, 2002, p. 247). A PPP arrangement typically has two elements with discrete cash flows attached to each (Grimsey & Lewis, 2002, p. 259). The first is construction and provision of an asset and the second is provision of services. These elements entail recognition and measurement problems, such as the assignment of values to assets to be received in the future (eg 20–30 years) and whether the assets and liabilities can be measured reliably (Grimsey & Lewis, 2002, p. 259). Standard setters have been working on these issues and more in order to provide users with transparent and reliable information. These efforts have led standard setters to, among others, IFRIC 12 Service Concession Arrangements and Exposure Draft 43 Service Concession Arrangements: Grantor.

### 6.1. Accounting for PPPs by private sector partners

Although not applicable to all forms of infrastructure service arrangements, IFRIC 12<sup>39</sup> was issued by the International Financial Reporting Interpretations Committee (IFRIC) for the accounting by the private sector operators that provide public sector infrastructure assets and services in service concession arrangements (SCAs) (Deloitte, 2007). IFRIC 12 excludes accounting by grantors and accounting for infrastructure that was recognized by the operator as property, plant and equipment (PPE)<sup>40</sup> prior to entering a SCA. According to IFRIC 12, the infrastructure should not be recognized as PPE of the private sector operator but as either a financial asset or an intangible asset or a mixture of both (bifurcated model) based on the nature of the consideration given by the grantor to the operator (Deloitte, 2007; BDO International, 2007, p. 2). Figure 16 shows the IFRIC 12

<sup>39</sup> Any SCAs within the scope of IFRIC 12 are excluded from IFRIC 4 *Determining whether an Arrangement Contains a Lease* (BDO International, 2007, p. 1).

<sup>40</sup> The derecognition requirements of IAS 16 Property, Plant and Equipment would apply to such PPE (BDO International, 2007, p. 1).

requirements with regards to the recognition of the nature of the consideration (Deloitte, 2007):

**Figure 16 Financial asset, Intangible asset, and Bifurcated model**

| Operator's rights  | Classification   |
|--|--|
| Unconditional, contractual right to receive cash or other financial asset from the grantor | <u>Financial asset</u><br>Revenue and costs relating to the construction or upgrade are recognized in income over the construction phase of the arrangement in accordance with IAS 11 Construction Contracts. A financial asset is under IAS 39 Financial Instruments which is recognized and measured as a loan or receivable, or an available-for-sale financial asset, or a financial asset at fair value through profit or loss, if the classification conditions are met. Monies received are treated as partial repayment of the financial asset. E.g. Operator receives a fixed amount from the grantor over term of arrangement, or an operator has a right to charge users over term of arrangement, but any shortfall will be reimbursed by the grantor  |
| Amounts to be received are contingent on the extent that the public uses the service       | <u>Intangible asset<sup>41</sup></u><br>During the construction phase the operator will recognize revenue in respect of construction activities, with the corresponding entry increasing the recognized value of the intangible asset. The intangible asset generates additional revenue when the operator receives cash from users or from the grantor based on usage. The intangible is reduced by amortization. Thus, revenue is recognized twice; once on the exchange of construction services for the intangible asset (IAS 11 Construction Contracts), and a second time on receipt of payments (IAS 18 Revenue). E.g. Operator has a right to charge users over the term of the arrangement, or an operator has a right to charge the grantor based on usage of the services term of the arrangement |
|  | <u>Bifurcated model</u>  |

<sup>41</sup> The intangible asset approach is said to cause revenue "grossing up" as the operator records higher total revenue (e.g. CU2,650) but only receives cash less than the recorded total revenue (e.g. CU1,600) over the term of the contract (BDO International, 2007, p. 2).

|  |   |
|--|---|
| Consideration received partly in the a financial asset and form of partly in the form of an intangible asset | Where the operator receives a financial asset and an intangible asset as consideration, they are accounted separately for the component parts. Initially, the assets are recognized at fair value. A financial asset will be recognized to the extent the operator has received a contractual right to receive cash from or at the direction of the grantor. Any excess of the construction services provided over the fair value of the financial asset recognized will be recognized as an intangible asset. E.g. an operator receives a fixed amount from the grantor and a right to charge users over the term of the arrangement |
|--|---|

Following IFRIC 12, New Zealand Institute of Chartered Accountants (NZICA) issued New Zealand Equivalent to IFRIC Interpretation 12 Service Concession Arrangements (NZ IFRIC 12) under the Financial Reporting Act 1993 effective 1 January 2008 (NZICA, 2007, p. 1). Subsequently, Malaysian Accounting Standards Board (MASB) issued IC Interpretation 12 effective 1 July 2010 (MASB, 2010, p. 21). This means that private sector partners in New Zealand and Malaysia are currently complying with the same standard since there are no modifications made to the original IFRIC 12 by both NZICA and MASB. Uniform standards such as this will promote comparability and transparency as well as minimizing opportunity arbitrage or ‘venue shopping’ between standards (Heald & Georgiou, 2008, p. 9). Hence, post-2010, comparisons between private sector accounting in New Zealand and Malaysia can be conducted more reliably based on IFRIC 12.

According to Deloitte KassimChan (2009, p. 20), IFIRC 12 requires additional disclosures in accounting for PPPs. An operator and a grantor need to disclose classification of SCAs every accounting period and the operator must also disclose revenue and profits or losses recognized on exchanging construction services for a financial asset and/or an intangible asset. Prior to IFRIC 12, Malaysian service concession companies recognize profits during construction as incurred or as part of the initial recognition of the concession asset. Post-IFRS convergence, the profits will be the fair value of work done and as the concession asset is being used, the operator’s restoration obligation will be accrued (PwC, 2009, p. 11). The justification for additional disclosures would be to promote transparency by presentation of more precise accounts of PPP transactions.

## 6.2. Accounting for PPPs by public sector partners

It is crucial that any chosen accounting rules should not deliberately favour PPPs over other procurements. In order to minimize the scope for accounting and budget rules to have an effect on the choice of the mode of a service delivery, governments should continuously revise their national budgeting procedures and systems to ensure a focus on affordability, VFM and long-term fiscal sustainability (OECD, 2008, p. 91). Otherwise, the accounting treatment could challenge VFM. Sue Newberry and June Pallot brought up the possibility of accounting related legislation manipulation to privilege PPPs in New Zealand. They (2003, p. 468-469) believe that New Zealand's Fiscal Responsibility Act (FRA) 1994 privileges PPPs and promotes off-balance sheet forms of public debt which they argue help institutionalize fiscal irresponsibility. Off-balance sheet treatment is very tempting because it makes unviable projects, viable. This is because an off-balance sheet treatment allows payments to the private sector partners to appear as revenue charges rather than an asset and a liability (Grimsey & Lewis, 2002, p. 261). Consequently, the government will be able to deliver public infrastructure and services without having to worry about liabilities. However, seeing that PPP-related activity in New Zealand is limited and localized, the perception that the FRA 1994 is meant to privilege PPP might be an overstatement. Since local governments of New Zealand, such as Auckland City Council and Wellington City Council, are more experienced in matters relating to PPPs than the Central Government, this chapter will make references to local governments of New Zealand in discussing accounting treatment for PPPs.

Due to the risks associated with PPP contracts, information relating to it should be made as transparent as possible without exposing the partners to unnecessary risks. The associated budgets and accounts must completely reveal actual and potential future payment obligations as well as information on how the contracts would affect cash flows, the risk of increased payments caused by guarantees and contingent liabilities, and whether the assets will be transferred to the government at the end of the contract period (OECD, 2008, p. 101). Choosing a PPP over a traditional procurement method affects the amount and the timing of government expenditures as PPPs often lock in government expenditures for a long time. This issue is heightened by the differing adoption of accounting principles by governments with the choice of cash basis, modified cash basis and accrual accounting. Since the NZG adopts full accrual accounting based on International Financial Reporting Standards (IFRS), New Zealand's public sector accounting is expected to be transparent.

On the contrary, the accounts of the GoM are prepared primarily on a cash basis<sup>42</sup> in compliance with cash basis IPSAS (International Public Sector Accounting Standards) which fundamentally revolves around cash receipts and payments in the current year, thus ignoring recognition of future transactions such as liabilities. Thus, Malaysia's accounts are lacking in transparency when compared to New Zealand's. It is likely that this could have allowed the GoM to pursue PPPs without reservation.

Accounting for PPPs by public sector partners has often been perceived as lacking in transparency especially when off-balance sheet accounting treatment is utilized. However, an overview of the UK's Ministry of Justice Resource Accounts 2008-09 shows that PFI accounting by the public sector partners can be transparent, even with off-balance sheet accounting treatment. The PFI transactions comply with the 2008-09 Government Financial Reporting Manual (FReM)<sup>43</sup> and Financial Reporting Standard 5 *Reporting the Substance of Transactions* (FRS 5) which allow for accounting of on- and off-balance sheet transactions. The report also utilizes the words 'off-balance sheet PFI' and 'on-balance sheet PFI' in the accounts. This makes it easier for the unsophisticated users of financial statements to detect PFI-related accounts. The account also specifies that:

*Residual interest in off-balance sheet PFI properties are included in tangible fixed assets at an amount equal to the unitary charge allocated for the acquisition of the residual interest to the balance sheet date. An adjustment is made based on the net present value of the change in the fair value of the residual interest, as estimated at the start of the contract and its estimated fair value at the balance sheet date* (Ministry of Justice, 2009, p. 72).

Note 28 of the report then specifies commitments under PFI contracts detailing project name, contract start date, duration (years), estimated capital value (£m) and description of both on- and off- balance sheet PFIs as well as obligations under on- and off-balance sheet PFI (operating leases). This is followed by *Charge to the operating cost statement and future commitments*. This resource account is prepared prior to IFRS convergence which will take effect in 2009-10. It will be advantageous to find out the impact of IFRS to the public sector accounting of the UK. Heald and Georgiou (2008) predict that the absence of public sector accounting for PPPs in IFRS will impose some implementation problems as PPP-accounting will only depend on FRS 5A to account for PPP transactions by the public sector.

<sup>42</sup> According to Accountant General's Department, modified cash basis of accounting is allowed for supplies and services received by 31 December that will be paid in the January of the following year via account payables.

<sup>43</sup> The FReM is issued by HM Treasury and follows UK Generally Accepted Accounting Practice for companies (UK GAAP) as deemed appropriate to the public sector.



Absence of standardized accounting treatment could tempt a government to move investment that would otherwise be considered public investment off the government's balance sheet, thus making it possible to avoid normal spending controls and to get around spending ceilings and fiscal rules (including moving expenditure to future budgets, increasing government liabilities and entering into guarantees to receive private financing) (OECD, 2008, p. 91). Ultimately, the taxpayers will have to eventually bear the risk of future high costs (OECD, 2008, p. 91). This then would negate rationality for choosing PPPs over other procurements. Noting the absence and the need for a standard, IFAC<sup>44</sup> (2008) examines the following:

1. Terminology clarification (eg: service concession arrangements, public private partnerships);
2. Adequacy of existing standards for addressing both known and anticipated service concession arrangements for both grantors and operators;
3. Symmetry of accounting for both parties to a service concession arrangement;
4. Implications for other arrangements governments may have related to the employment of their capital assets e.g. leasing, sale-leasebacks or other arrangements;
5. Recognition of infrastructure subject to service concession arrangements; and
6. Recognition of revenue and expenditure flowing from these arrangements.

Following these, the International Public Sector Accounting Standards Board (IPSASB) issued Exposure Draft 43 Service Concession Arrangements: Grantor (henceforth ED 43) (IPSASB, 2010). IPSASB intended for the ED 43 to mirror IFRIC 12 so that accounting by both partners would complement each other's accounts of PPP transactions. If ED 43 is adopted, then the off-balance sheet treatments will depend on 'control' instead of 'bearing the majority of risks and rewards of ownership' (Heald & Georgiou, 2008, p. 20). According to ED 43, the grantor shall recognize a service concession asset as an asset if (IPSASB, 2010, p. 10):

1. The grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and
2. The grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the asset at the end of the term of the arrangement.

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<sup>44</sup> These issues and more are addressed in the March 2008 proposal by the International Public Sector Accounting Standards Board entitled *Accounting and Financial Reporting for Service Concession Arrangements* is available on IFAC's website.

This means that if the public sector partner/grantor satisfies this control criterion, then the service concession will require an on-balance sheet treatment by the grantor. The asset will be recorded as an intangible asset or property, plant and equipment. The move from risks and rewards criterion to control criterion is led by the hunt for a more objective and consistent criteria to promote ‘symmetry’ in the accounting treatment by both public and private sector partners (IPSASB, 2010, p. 28; Heald & Georgiou, 2008, p. 20). The risks and rewards criterion is deemed problematic to achieve objective assessments. Also, it focuses on the economic aspects of the arrangement which neglects the fact that an SCA primarily provides service potential on behalf of the public sector (IPSASB, 2010, p. 28). In contrast, the control criterion focuses on control over the service potential of the service concession asset and hence acknowledges an SCA’s primary purpose (IPSASB, 2010, p. 28). New Zealand responded well to this change and has expressed consent to using this control criterion in determining whether a grantor report the property underlying a SCA as an asset (Brady, 2008, p. 2) and thus, New Zealand has deemed ED 43 as appropriate (Packer, 2010). Unfortunately, Malaysia’s stance on these matters has yet to be published, potentially because the GoM does not abide by accrual accounting.

Under ED 43, a liability is recognized with on-balance sheet treatment and when the government is contracted to make service payments over the life of the contract. The liability is calculated from the discounted sum of the service payments. Practically, it represents the construction cost plus the net present value of the operating and maintenance costs over the life of the contract (NIU, 2009, p. 14). This liability is treated the same way as interest payable on government debt, as if the project was financed with Crown debt (NIU, 2009, p. 12). NIU’s PPP guide specified that the accounting treatment for any specific proposal should be consulted with the Treasury of New Zealand (NIU, 2009, p. 14). This means to account for a PPP project, the Treasury must be made aware of the project itself to provide consultation on the project. This will provide the Treasury with the experiences it will need to devise a robust PPP framework.

Another issue lies in exclusion of PFIs from the national accounts. According to Vass and Donald (2010, April 18) most PFIs are excluded<sup>45</sup> from the national accounts because according to international accounting conventions, only current debts are supposed to be included, not future debts. This arguably understates national debt which consequently put the nation in deeper debt than announced. In New Zealand, according to Newberry and

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<sup>45</sup> The latest UK Government estimate of the deficit, excluding PFI, is pound(s)167bn, which would rise to pound(s)224bn if PFI was included.

Pallot (2003), the FRA 1994 favours the private sector involvement in the provision of public services via accounting means by classifying future PFI-equivalent payments as not 'liabilities' but 'commitments' without counting on key national economic indicators and target (Broadbent & Laughlin, 2003, p. 338).

Note 32 *Commitments* of Auckland City Council's financial report (2009, p. 234) provides an example of this practice.

|                        | Council        |                | Group          |                |
|------------------------|----------------|----------------|----------------|----------------|
| \$000                  | Actual<br>2009 | Actual<br>2008 | Actual<br>2009 | Actual<br>2008 |
| Capital commitments:   |                |                |                |                |
| Right to acquire asset | 257            | 2,465          | 257            | 2,465          |

Considering that a liability is recognized when the government is contracted to make service payments over the life of the contract, the absence of liability recognition could indicate that the Council has no service payment obligation to Quay Park Arena Management Limited (QPAM), unless the liability has not been distinguished from other liabilities in its class. However, this example shows that *commitments* replaces liability as claimed by Newberry and Pallot. They (2003, 476) added that *commitments* are excluded from estimates of appropriations (submitted to parliament) because *commitments* are future expenses and liabilities whilst the estimates *only deal with expense and expenditure amounts relating to the budget year* (this would be of concern in a Central Government Department.). This treatment *overlooks "contingent liabilities" which would include PFI*. In the UK, HM Treasury responded to similar transactions (Vass and Donald, 2010, April 18):

*HM Treasury has noted the Committee's points and has already taken a number of steps in these areas to improve the availability of data on PFI projects. Departments will publish their resource accounts on an IFRS basis in summer 2010, and these will reflect the PFI accounted for under IFRS. Whole of Government Accounts (WGA) will be published around spring 2011 and will also reflect PFI on an IFRS basis. Reconciliation between National Accounts debt measures and WGA on an IFRS basis will be provided.*

This shows that proper accounting of PPP is capable of telling the stories behind a PPP project. If the accounting treatment is ambiguous, the account could be telling a different

story. Additionally, governments should incorporate national procedures in the budgeting systems to deal with PPP contracts (OECD, 2008).

There are few examples of PPPs in New Zealand from which to analyse the accounting for PPPs. The examples quoted so far have been from Local Government where partnerships have enabled assets to be built for public use. In 'note 32' above and in Figure 17, the accounting for these PPPs is further examined. The following examples will show that compliance with IFRIC 12 by New Zealand's public sector appears consistent with ED 43.

The following is constructed from Auckland City Council annual reports (Auckland City Council Annual Report 2008/2009, 2009, p. 192; Auckland City Council Annual Report 2007/2008, 2008, p. 159; Auckland City Council Annual Report 2006/2007, 2007, p. 147)

**Figure 17 Right to acquire asset**

| Note 4 Right to acquire asset           | Parent/Council |         |        |        | Group   |         |        |        |
|---|----------------|---------|--------|--------|---------|---------|--------|--------|
| \$'000                                  | 2009           | 2008    | 2007   | 2006   | 2009    | 2008    | 2007   | 2006   |
| <b>Vector Arena</b>                     |                |         |        |        |         |         |        |        |
| Opening balance                         | 69,674         | 69,266  | 61,712 | 31,418 | 69,674  | 69,266  | 61,712 | 31,418 |
| Additional capital expenditure          | 1,711          | 408     | 7,554  | 30,294 | 1,711   | 408     | 7,554  | 30,294 |
|   | 71,385         | 69,674  | 69,266 | 61,712 | 71,385  | 69,674  | 69,266 | 61,712 |
| <b>Wynyard Point public space</b>       |                |         |        |        |         |         |        |        |
| Opening balance                         | 50,841         | 0       | 0      | 0      | 50,841  | 0       | 0      | 0      |
| Capital expenditure                     | 0              | 50,841  | 0      | 0      | 0       | 50,841  | 0      | 0      |
| Deduct capital expenditure over-accrued | -185           | 0       | 0      | 0      | -185    | 0       | 0      | 0      |
|   | 50,656         | 50,841  | 0      | 0      | 50,656  | 50,841  | 0      | 0      |
|   |                |         |        |        |         |         |        |        |
| Right to acquire asset                  | 122,041        | 120,515 | 69,266 | 61,712 | 122,041 | 120,515 | 69,266 | 61,712 |

The Council subsidized \$68.2 million of the \$80 million Vector Arena and QPAM funded the remaining \$11 million. According to Figure 17, the *right to acquire asset* for the year 2007/2008, represents the Auckland City Council's contribution to the Vector Arena and the deposits paid to acquire public space for the Wynyard Point development (Auckland City Council Annual Report 2007/2008, 2008, p. 159). The Council will review the recoverable amount of the Vector Arena annually for impairment testing. The *right to acquire asset* is explained by the Auckland City Council as the right to acquire physical assets owned, managed and operated by a third party (Auckland City Council Annual Report 2007/2008, 2008, p. 148). It is recorded as an intangible asset with the component relating to the residual value of the asset recorded at cost. Impairment testing allows for the third party requirement to maintain the asset's service potential and return the asset in identical condition (Auckland City Council Annual Report 2007/2008, 2008, p. 148). The component relating to the service potential to be received over the concession period is recorded at cost, less amortization and impairment losses until the asset reverts to Auckland City Council and it is amortized over its useful life and is subject to impairment testing (Auckland City Council Annual Report 2007/2008, 2008, p. 148). This accounting treatment provides an example of concession service asset being recorded in accordance to IPSAS 31 Intangible Asset.

Another example of PPP accounting in New Zealand involves the Wellington City Council's Clearwater Sewerage Treatment Plant (Moa Point). The Council owns the plant and United Water International (UWI) operates it under a design, build, operate and transfer contract. In the Council's financial report, the plant and building assets are classified under PPE under the drainage, waste and water asset class (Note 17 of the annual report). As the asset owner, the Council incurs all associated operating expenses, namely management fees, depreciation and finance costs. In accordance with section 100 of the Local Government Act 2002, the Council does not fully rates fund the plant's depreciation expenditure. UWI's monthly management fee is determined in accordance with annually adjusted tariffs. However, the exact amount contributed by the plant is unknown to the public (Wellington City Council, 2010, p. 177). Prior to the Council's 2008/09 annual report, there is no mention of the plant or service concession arrangement in its financial report because NZ IFRIC 12 compliance started on 1 January 2008. This example is consistent with ED 43 which provides an example of recording a service concession asset with IPSAS 17 Property, Plant and Equipment.

Although not as detailed as the UK's, the Auckland City Council's financial statements provide accurate information on transactions involving the Vector Arena. As for Wellington City Council's reporting, although there is specific mention that the plant is resulted from an SCA, the exact amount contributed by the plant is unknown since it is included under drainage, waste and water asset class. More importantly, Packer (2010, p. 1) mentions that *service concession arrangements have not been a feature to date of the New Zealand environment*, despite OAG's report on Auckland's Vector Arena and Wellington's Clear Water project in 2006 and both Councils' reports on their SCAs. This seems to show the lack of interest in PPPs in New Zealand despite Packer's report on the growing interest in PPPs, although arguably Packer could be referring to the Central Government's SCAs.

Since financial statements of QPAM and UWI are not accessible, it is not possible to understand how accounting treatment by both partners mirror each other. This might indicate the problems of limitation to information due to commercial confidentiality when private sector entities provide public services. Therefore, future research on the application of IFRIC 12 by the private sector partner and IFRIC 12's mirror by the public sector partner might be helpful in detecting any possible issues that could materialize from the compliance of IFRIC 12 and its mirror.

Hemming (2007, p. 5) states that accounting for PPPs is further challenged by the ambiguous basis on which the private sector uses the asset, asymmetric government and private sector accounting, and inclusion of numerous imputed items in fiscal accounts. It is argued that (Hemming, 2007, p. 8):

1. Classifying PPP assets as government or private sector assets does not do justice to the fact that PPPs are designed to share risk according to which party can manage it best;
2. The fiscal costs and risks associated with PPPs, which are derived mainly from an obligation to make future service payments and to honour called guarantees should be assessed, quantified and disclosed;
3. Either a larger flow of future public spending or a larger stock of government liabilities can be reported;
4. Disclosure can substitute for or complement the financial lease/Eurostat (European Commission) approach; and
5. Where PPP and/or guarantee programs are large, a comprehensive statement on these programs should be part of the budget documentation.

Hemming's concerns are directed at the need for fairer and more accurate reporting that precisely reflects the contribution of both partners in PPPs. Hence, in accounting for PPPs more disclosures would be favourable. No doubt these will be informative but could the benefits of more disclosures outweigh the costs of preparing and providing them.

### **6.3. Summary**

Accounting and reporting issues of PPPs originate from the lack of information about PPP transactions and delimitations of PPPs. This chapter has presented examples of how ambiguous PPP accounting can be without proper and standardized guidance. Even the UK is still perfecting its PPP framework. Because of this, different countries have different approaches to account for PPP assets, potentially despite IFRS convergence. This warrants the need for additional disclosures for transparency, especially when accrual accounting is not implemented. The public sector procurer should hence be cautious of potential changes in generally accepted accounting practice when identifying information to be provided by private sector parties during the course of PPP arrangements. This means any changes affecting recognition of assets and obligatory disclosure should be disclosed appropriately.

As seen from this chapter, there are a number of issues that surround accounting of PPPs especially with accrual accounting adopters. The need for transparent and precise accounts of PPP transactions makes accounting for PPPs quite challenging. Since the GoM does not comply with accrual accounting, it is not restricted by these issues which allow the GoM to go for PPPs more progressively but with no transparency.



## 7. Other issues of PPPs

Each procurement method comes with their own sets of challenges and issues. Accordingly, there are challenges in justifying PPP-adoption, in working the best features for PPP framework, in allocating risks, in evaluating performance, and in accounting for PPPs. It is the intention of this chapter to point some of these out, in particular accountability, financing challenges, public opinion and tolling, and a government's obligation towards nation development.

### 7.1. Accountability

Accountability remains one of the main PPP issues. Australia noted that barriers to public accountability in PPPs include the diffusion of disclosure resulting from multiple reporting entities; uncertainties surrounding the mechanics of risk transfer; and the opportunistic use by governments of commercial confidentiality clauses (English & Guthrie, 2006, p. 13). Furthermore, findings by three Australian Public Accounts Committees show that governments themselves insist on the lack of disclosure, not private contractors (English & Guthrie, 2006, p. 13). As shown in chapter 6, lack of disclosure has induced excessive off-balance sheet accounting treatment and allow for more PPPs without having to worry about being scrutinized. This is especially so in Malaysia since modified cash basis accounting allows selective information to remain hidden; unlike New Zealand's accrual accounting that promotes transparency. Plus, concerns have been raised over potential erosion of the service ethic and ethos of the public sector (Plant, 2003, p. 560) because the private sector interest in public goods and services could potentially taint the characteristics of the public sector which include motivation, professionalism, trust, impartiality, and judgment (Plant, 2003, p. 561-564) as discretion and judgment are indispensable (Plant, 2003, p. 577). Whilst discretion, choice, personal judgement, and experience run the private sector environment, the public sector works for the general public which can be complex and abstract e.g. good education (Plant, 2003, p. 565-566). However, this does not mean that one sector is purer than the other, as it only shows that the partners operate in different environments. The concern here is the perception that the drivers for both sectors could have infused under PPPs, thus disrupting public accountability. Plant (2003, p. 564) emphasizes that *it is difficult to see how cooperation will work without the public sector ethic being*

*transformed out of all recognition.* Plant also pointed the blurred line between policy and implementation which could have triggered accountability loss (Plant, 2003, P. 574):

*...some asymmetry in motivation between those who write the contract and those who implement it because the latter may have an incentive to use their discretion ... in a way not wholly consistent with the policy defined in the contract itself ... there has to be a high degree of trust between the state as the contracting party and the private sector body as the contractor* (Plant, 2003, p 575).

This shows the vulnerability of contracting with fundamentally different motivations. Plant added that a contract works best with trust, promise-keeping, truth-telling, respect and integrity (Plant, 2003, p. 576). In working out accountability, trust will need to be sorted out first as the rest of the contract will be influenced by trustworthiness of both partners. Obviously, trust influences accountability.

Both in New Zealand and Malaysia, public services and infrastructure are essentially the responsibility of the respective governments regardless of procurement arrangement. According to the OAG (2006, p. 24), despite partnering arrangements, the government continues to be responsible and accountable for the project or service to protect public benefit. Aziz Bahaman as vice President of Master Builders Association Malaysia said that even in a PFI, GoM continues to be responsible for providing the service to the public (Yusoff, 2007). Therefore, a PPP does not release the public agencies from their responsibilities as it merely assists them in performing their duties. This informs the inability to totally transfer risk.

In New Zealand, the OAG requires public entities to provide *complete and accurate accounts* of public funds spending even if the funds had been passed on to others (OAG, 2008a, p. 9). In finalizing a PPP contract, the public sector should therefore consider requirements for access to information as contained in the Official Information Act 1982, Local Government Official Information and Meetings Act 1987, audit and other public accountability requirements such as the Public Audit Act 2001 (OAG, 2006, p. 41). The rights of each partner to information and reporting requirements need careful and accurate specification in the contract, on top of the limits of commercial confidentiality as these will affect responsibility and accountability.

In Malaysia, accountability is challenged by money politics where money rules almost everything. Accountability deficiency may point to unethical behaviour that relates to information asymmetry, collusion, conflict of interest and political financing (OECD, 2008, p. 122-123). An article by Teh (2002, p. 345) showed that Malaysia has the adequate laws to control money politics but due to non-compliance by both the politicians and the general public, the problem continues. This indicates that the major problem lies in law enforcement. Laws would be useless unless enforced. Otherwise, accountability in Malaysia can easily be bought.

## 7.2. Financing challenges

Another challenge in pursuing PPPs lies in private financing. Newberry believes that PPPs will be more expensive than if the government were to borrow and build the buildings itself because effectively taxpayers will be paying for them (Partnership report card varied, 2007, p. 15). Since most PPPs are financed through heavy borrowing by the private sector partner who always pays higher interest rates than a government, PPP projects are deemed costly (The Press, 2008). Fletcher claims that many New Zealand projects are too small for a PPP arrangement because a PPP is normally intended for large and expensive projects, thus causing the concern about PPP costs since the market had not really developed (Gibson, 2008). Indeed, if only the difference in interest rates payment is looked at, the private sector partner would have paid more interest. However, it has been argued that if the whole costs of undertaking the project are considered, it would be cheaper to have the project delivered via a PPP since theoretically a PPP is undertaken after PSC evaluation shows that VFM is achievable. NIU (2009, p. 16-21) clarifies that there is no reason to believe that the government's cost of capital is lower than the private sector's cost of capital because:

1. Refinancing gains are shared between the government and the private party to reduce the perception that the contractors are making excessive profits;
2. The total cost of capital, the sum of the cost of debt and the cost of equity, matters more than the assertion that the government's cost of borrowing is less than the private sector's; and
3. The excessive risk premium demanded by private sector investors does not relate to government's lower cost of capital because if private sector investors demand a high risk premium, presumably they will also demand it when investing in

government projects by way of the taxpayer guarantee associated with government borrowing.

This clarification however, does not explicitly deny that government's cost of capital is lower than the private sector's. Recall that a PPP may only be pursued when there is an absolute need for it (as mentioned in chapter 3). In other words, the cost of capital will not matter if a PPP could deliver better services better than the government. The real issue here could be that with PPPs, the end users might have to pay for services that some argue they have already paid for via taxes. However, in utilizing a PPP, it has been advised that resources allocation that does not go to a PPP because of private financing will go to other pivotal projects. Consequently, it is presumed that more projects can be done to fulfil societal need.

### **7.3. Public opinion and tolling**

Adverse reaction to tolling is the main reason roading-related PPPs are rejected. The Waterview Connection Steering Group reported conflicts to tolling which is consistent with international experiences (Report of the Waterview Connection Steering Group, 2008, p. 26). The public opposition to tolling may be influenced by a self fulfilling theory and also by what they perceive as reasonable toll rates. However, the public appear to be more willing to accept tolling when they have accepted the fact that new roads could not be constructed without toll revenue (Report of the Waterview Connection Steering Group, 2008, p. 26). Auckland Green Party MP Keith Locke criticized the recommendation to build the Waterview Connection using a PPP as too expensive, a projected cost of \$1.9 billion, for a mere 4.5 kilometre motorway that is not urgently needed.

Overseas experience shows that private sector involvement does not make the projects more cost effective, partly because private sector partners always protect themselves contractually against uncertainties (Locke, 2008). Having predicted that any private sector entities would want to prudently protect themselves against the risks allocated to them, it seems logical for the general public to defy PPPs. Thus a PPP implementation should be made as transparent as possible to avoid misjudgements among the end users about PPPs.

According to Fletcher, PPPs would be a retrograde step for New Zealand because PPPs are time consuming especially in setting up legal framework between participants (Gibson, 2008). This means it would be likely that a project will have to be delayed until both partners are satisfied with the contractual terms. Broadbent and Laughlin (2003, pp. 336) address the private sector partners scepticism against public service provision mainly because they *clash with, the values and ethos of the public sector* since they prioritize profitability and their shareholders. This issue is commonly brought up. It is quite likely that in detailing contract terms, both partners have come up with a solution that evenly weight respective motivation for undertaking the projects. It is then becomes the responsibility of the public sector partner to ensure that its partners are on the agreed track.

Two major public consultations and market research show that 64 per cent of public surveyed supported the proposal on the development of Vector Arena as a PPP whilst 34 per cent did not (Auckland City Council Annual Report 2008/09, 2009). Although not everyone is supportive of Vector Arena being delivered and operated by a private sector entity, it shows that there are supporters of PPPs in New Zealand.

Takim et al. (2008, pp. 71) studied the acceptability of PFI in Malaysia using a questionnaire survey to public and private sectors in Malaysia and noted the need to reduce the length of time, the use of excessive budgets, the problems of cost overruns, and the delivery of inferior works and substandard construction products. Although a PPP could potentially provide these needs, the public is concerned that the adoption of PPPs would mean less disposable income or savings for them whilst the private sector enjoys excessive profits. This is mainly driven by the concern that the private sector, being profit-driven, will try to make profit from the public money eventually either by charging the public more than necessary or by having the government to bail the project out when faced with failures. Also, given that the public pays taxes and other funds to the government, it will only make sense for the government to utilize the paid taxes rather than having the public to pay extra for the private sector delivered infrastructure, additional to the obliged taxes. Aversions to PPPs may originate from lack of exposure on PPP implementation along with the news on PPP failures. Therefore, it would be a good idea to educate the public on PPPs.

The Malaysians have always been curious about toll concessionaires in Malaysia and there has been increasing demands for this information. In response, the GoM succumbed to the demands and declassified toll concessionaire agreements since 5 January 2009. The

declassification however, raises more questions in need of answers as stated by Yeow and Mokhtar (2009). This is because of the lack of standardized approach in dealing with concessionaires, the absence of a formula to calculate compensation to keep toll rates affordable, and the high dependency of the concessionaires on government loans (Yeow & Mokhtar, 2009). Further, there is a restriction on this declassification due to private sector involvement which warrant some degrees of commercial confidentiality. Consequently, although the documents can be viewed in person, these documents are not to be published online and no copies can be made from the original documents.

#### 7.4. Towards equitable nation development

An issue of PPPs in Malaysia lies in the preference for small *bumiputera* contractors. This is because 60% of all capital works should be awarded to *bumiputera* entrepreneurs whose financing and constructing capability is perceived as dubious (Jayaseelan and Tan, 2006, pp. 97). This raises the concern that Malaysia's PFI may be futile since the allocated RM20 billion prioritized to small *bumiputera* entrepreneurs whose ability to deliver on time and on budget is questionable. They believed that the allocated RM20 billion should have been given to the financially secured *big players*, thus exempting EPF involvement in PFI (Jayaseelan & Tan, 2006, p. 97). Gunasegaram added that most of the small *bumiputera* contractors *subcontract to the real contractors* and that substandard results are caused by *too little money for the real contractor at the end of the line* (Gunasegaram, 2006, p. 100). To fight off this scepticism, interested small *bumiputera* contractors will have to continuously perform well for the competitive tender and bidding process.

According to Ninth Malaysia Plan 2006-2010 (2006, p. 228) *only capable entrepreneurs were selected to undertake construction works and participate in vendor development programmes*. These would have eliminated the less capable ones. Jayaseelan and Tan (2006, p. 97) referred to the UK success which requires competitive tendering, sound bidding process and strict performance-based payment to the private parties. They hinted at the concern that tendering process, bidding process and performance based payment could have been manipulated for *bumiputera* contractors. PFI Sdn Bhd<sup>46</sup> will provide financing to successful project bidders, which are expected to be privately held ethnic Malay

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<sup>46</sup> A special purpose firm established by the Finance Ministry will be tasked with implementing the new investment vehicles.

consortiums, which will manage all aspects of the project (Netto, 2006). Also, P Gunasegaram (group executive editor of the business weekly, the Edge) said (Netto, 2006):

*The [ethnic Malay] contacting community is a strong lobby group within UMNO [United Malays National Organization, the dominant party in the ruling coalition] but that does not mean the government has to cater to them by putting together a scheme that will benefit them and give them access to funds when of them may not deserve it*

Many seem to believe that EPF is meant to especially help the small *bumiputera* contractors and this belief is partly true. According to Ismail & Md. Yusof (2009b, p. 85) it is the intention of the GoM to assist capable *bumiputera* contractors. However, there is more. ...*even if it is government policy to protect the contractors and to give them more experience, arrangements can be made on multi-racial grounds to ensure that both the big and small contractors are adequately catered for* (Beh, 2010, S80). It is possible for the small contractors to experience PPPs as preparation for future competency, although simultaneously the financial aid could potentially compromise the true PFI during this 'trial' period. However, in considering globalization, every business needs to be competitive to survive the global market. Hence, it is necessary to elevate local competition.

Curiosity might originate on the question of how PPPs can flourish with Malaysia's *modest* market size and the perception that Malaysia is descending the Transparency International's Corruption Perceptions Index (CPI) which could limit PFI growth in Malaysia (The Edge, 2009b). Moreover, GoM's efforts to combat corruption are not likely to be fruitful anytime soon (Beh, 2010, p. S80). According to Azmi & Associates (2008), since PFI has been associated with *corruption, nepotism, cronyism and 'bail-out'-ism*, as of 9MP, GoM abolishes '*bail-out'-ism* and focuses on *stricter requirements and penalties* for quality and capability. Most importantly, GoM needs the *political will* to defy those whose interest could be compromised (Azmi & Associates, 2008). Although, the '*bail-out'-ism* allows uninterrupted public services, the chosen private sector partners should not have needed bailing out. However, GoM may intervene under predetermined conditions (Ninth Malaysia Plan 2006-2010, 2006, pp. 226-227).

Some authors condemn this bailing out activities as the public benefit is at stake, a government cannot afford to let public service halted on the account of the private sector partner's failure to deliver. To a degree, it might be onerous for the private sector partner, to deliver highest quality at government's limited budget. Because of this, the chosen bidders should ideally have high reputation with large capital and able to fund the construction. On the other hand, partnering with the government for a long term ensures the on-going of the companies because of the longevity of a government.

Yong and Chew (2006) suggested that GoM tackles the following challenges:

1. strengthen the institutional framework or adopt new comprehensive legislation to govern the PPP and PFI;
2. the government should discourage evaluating unsolicited proposals from the private sector unless they are prepared to be subject to an objective and rigorous financial, technical and legal evaluation;
3. set clear guidelines and procedures for all user-ministries, to ensure consistency in implementation;
4. set up clear regulations and empower the regulators through legislation and capacity-building to enable stringent marking of privatized entities to performers; and
5. address the mismatch in terms of short term borrowing versus long term payments for PFI projects i.e. long term financing schemes through local financial institutions including the EPF.

## 7.5. Summary

With greater acceptability, it is fair to expect that challenges to PPP implementation would decline. This is because the commotion about PPPs appears to be due to the idea of relying on the private sector for public assets and services. It is thus the responsibility of both sectors to justify the need for PPPs clearly. The challenges in choosing and using PPPs may change over time and across countries. As each challenge is addressed, a new challenge could surface. Most of these challenges are similar and countries which have undergone such challenges may choose to share their experiences with other countries. For



example, prior to VFM recognition, the UK and Australia had stumbled upon many PPP failures. By publicizing about VFM, other countries can learn about PPP implementation better with less cost.

Some of these challenges to implement PPPs are initiated from the reactions of the concerned public. Public support is important for PPPs, especially with key public services such as transport or access to water. In light of the challenges presented previously, how does the general public react to PPP? The support of stakeholders who are directly affected by the creation of PPPs such as the public or employees is vital. If public opposition is large, support from political authorities for PPPs may dither, thus increasing the political risk of the PPP. This might dissuade private sector from participating in PPPs, thereby reducing competitiveness for the PPP project and subsequently undermining VFM. Therefore, in addition to performing the *ex ante* financial and risk analyses, a government should further the *ex ante* exercise to engage with all possible stakeholders for support (OECD, 2008, p. 118).

One of the ways to deal with these challenges requires thorough consideration of the following procurement stages which are vulnerable to corruption (OECD, 2008, p. 124):

1. the selection of consultants;
2. the design and preparation of tender documents;
3. the actual bidding procedure; distinguish the risk factors for competitive bidding, restrictive competitive bidding and direct acquisition. The rules of competitive bidding can be short-circuited e.g. the setting of a brief timeframe, insufficient publication, and biased design;
4. the decision phase; and
5. should not underestimate risks in the actual execution phase.

These stages are delicate and every decision made in each stage will influence the following stages and ultimately affect the overall project performance. Thus these must be closely inspected to filter against self-interested parties and measures against corruption should be in place. It is crucial that each stage should be as transparent as possible so the best decision can be made. Otherwise PPPs undertaken without proper deliberation could lead to poor public accountability, a reduction in competition and development of monopolies (Ismail & Md. Yusof, 2009b, p. 76). All of these could induce moral hazard

problems which would negatively affect integrity and reputation of everyone involved, hence adversely affect the rationality for PPPs.

## 8. Conclusion

This thesis has reviewed literature in order to understand the reasons behind Malaysia having more PPPs in New Zealand when both countries have a PPP-specialized unit, PPPs guidelines and acknowledgment of the potential of PPPs. In order to understand this trend, this thesis has presented issues relating to the reasons for PPPs, features of PPPs, risk allocation, performance indicators, accounting for PPPs and other issues relevant to PPPs.

It can be seen that rational choice theory is a prime reason to enter PPPs. That is, the public and private sector partners seek to optimize infrastructure and service delivery amidst the constraints related to providing public services. By joining forces, the public and private sector partners can minimize risks and maximize resources towards high quality public service provision. Theoretically this explains countries' preference for PPPs.

However the impact of transaction cost economics is also visible. Partners have limited knowledge about public service delivery especially because of the long term provision. This relates to bounded rationality that limits perfect knowledge to everything. This problem is heightened by opportunism whereby both sectors are prone to act opportunistically to pursue their self-interests which causes clashes in partnerships. Ultimately, this will adversely affect a PPP project and eventually cause failures that are costly and burdensome to taxpayers. This could be the reason for New Zealand to have limited number of PPPs that are localized.

Although both New Zealand and Malaysia each have a PPP-specialized unit that has published PPP guidelines in the same year, Malaysia has taken on more PPPs than New Zealand. The reason behind this is led by the motivation to pursue PPPs. While PPPs are entered into to deliver high quality infrastructure, Malaysia has a goal (Vision 2020) for more infrastructure that can only be achieved by involving private sector in public service provisions. Past experiences with its privatization programmes also act as a catalyst for more PPPs to achieve this goal.

Conversely, PPPs in New Zealand are limited by the aversion of including private sector entities in public service provision. Additionally, New Zealand's legislation is embedded with some constraints against PPPs and these constraints are accompanied by a number of stages that must be satisfied before a PPP can be considered. Such constraints are absent in

Malaysia as the government is convinced that PPPs can accelerate national development and hence the government has been encouraging the private sector entities to enter into PPP arrangements with the public sector (especially *bumiputera* contractors). Although the private sector financing has been argued as expensive, there is some merit to undertaking PPPs. The Government of Malaysia would not require EPF to help with PPP financing, had PPPs been worthless. Plus, even if the government could undertake the projects more cheaply, if the money is not there, then, it would not matter.

The issue with illusory risks transfer has also contributed to New Zealand not having more PPPs. Although Malaysia is also facing the same issue, seeing that the government is pro-PPPs, the threat of illusory risks transfer does not seem to bother the Malaysians as much as EPF funding these PPPs. There has not been a definite way to detect the flow of risks to determine whether they have been transferred. However, if risks have been successfully transferred and borne correctly, then the end result will reflect this. Otherwise, it could signal illusory risk transfer or poor risk management. When it comes to performance indicators, as New Zealand is more concerned about the overall performance management including KPIs, Malaysia is too focussed on developing the perfect set of KPIs which will be better developed from more PPP experiences. Moreover, Malaysia's accounting for PPPs by the public sector is much more secretive than New Zealand's, which makes it easier for the government take on more PPPs without attracting too many criticisms from the general public.

The conclusion of this paper is restricted to the examples presented in discussing PPPs in New Zealand and Malaysia as issues are selected based on their assistance in comprehending PPPs in New Zealand and Malaysia. It is not the intention of this paper to cover all PPP arrangements and all issues pertaining to every type of PPPs. Therefore this conclusion may not be relevant to all PPPs in these countries. Since PPP guidelines are subjected to on-going revision, the relevance and reliability of this paper rely on the current acceptable framework and practices of PPP. Further research including gathering data on organisations' experiences would be useful and the way in which rational choice theory informs their decisions.

## **Appendix A**

A completed PPP proposal should go directly to the relevant ministries or agencies detailing these (3PU, 2009, p. 7-8):

1. An executive summary of the submission
2. An evidence of financial stability and statement of financial capability, including access to capital (debt and equity), and Letters of Support from potential lenders
3. A statement of performance capability with an overview of overall experience, experience in similar projects, senior management expertise, expertise of those staff members who will work on the project, ability to obtain necessary resources and references
4. Results of economic, financial and engineering feasibility studies, including socio-economic cost benefit analysis (SCBA)
5. A business plan, including: partnership structure; duration of the proposed partnership; ownership (present and future); terms of payment; maintenance costs; reserves that need to be kept by the private partner; risk management, including that of force majeure; risk transfer from the government to the private sector partner; economic benefits to the government
6. A financial plan, including: detailed cost schedule; financial structure; potential partner's sources of funding; how improvements, upgrades and modifications will be financed; pro forma financial statements
7. The PPP modality options and the preferred option, concession period, risk analysis and allocation and financing scheme
8. The proposed payment mechanism based on service-delivery output specifications and KPIs. For infrastructure or service delivery partnerships where public user fees will be a source of revenue, a detailed year-by-year description of future user fees and their justifications. Include results of public interest surveys, if any
9. Additional information required will be available in the specific tender document of the project

## **Appendix B**

References to New Zealand equivalent to IFRIC Interpretation 12 Service Concession Arrangements include (NZ IFRIC 12) (NZICA, 2008, p. 6):

1. *NZ Framework for the Preparation and Presentation of Financial Statements*
2. *NZ IFRS 1 First-time Adoption of International Financial Reporting Standards*
3. *NZ IFRS 7 Financial Instruments: Disclosures*
4. *NZ IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*
5. *NZ IAS 11 Construction Contracts*
6. *NZ IAS 16 Property, Plant and Equipment*
7. *NZ IAS 17 Leases*
8. *NZ IAS 18 Revenue*
9. *NZ IAS 20 Accounting for Government Grants and Disclosure of Government Assistance*
10. *NZ IAS 23 Borrowing Costs*
11. *NZ IAS 32 Financial Instruments: Presentation*
12. *NZ IAS 36 Impairment of Assets*
13. *NZ IAS 37 Provisions, Contingent Liabilities and Contingent Assets*
14. *NZ IAS 38 Intangible Assets*
15. *NZ IAS 39 Financial Instruments: Recognition and Measurement*
16. *NZ IFRIC 4 Determining whether an Arrangement contains a Lease*
17. *NZ SIC-29 Service Concession Arrangements – Disclosures*

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