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MOVING TOWARDS A NEW PPP MODEL?

**BY CENTRE OF EXCELLENCE ON SUSTAINABLE FINANCE FOR
INFRASTRUCTURE AND SMART CITIES – EXSUF**

Towards a new model of PPP?

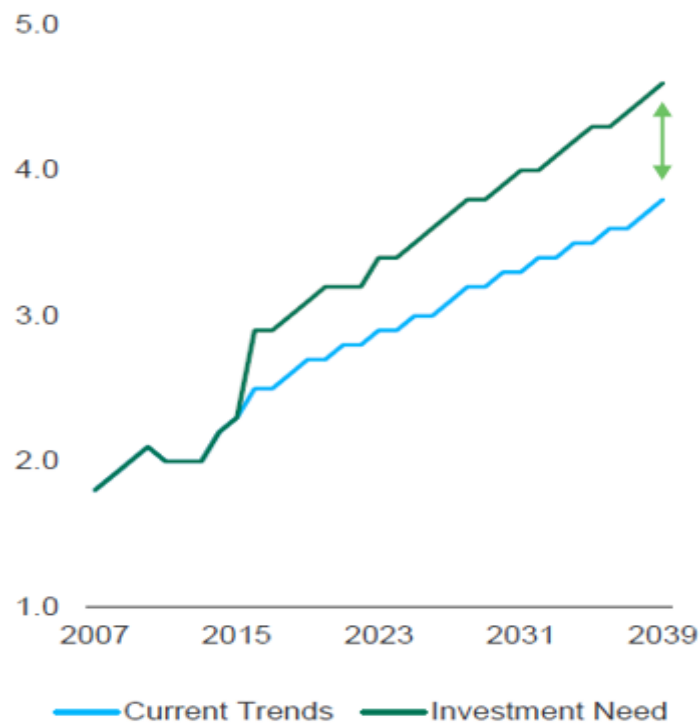
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Introduction

The recent entry into force of the new Public Contract Code (Legislative Decree No. 36 of March 31, 2023) represents an excellent opportunity to revisit and delve into the opportunities that Public-Private Partnerships (PPPs) offer. This instrument, which has been underused in Italy so far, has all the credentials to mobilize private resources for infrastructure financing and the provision of public services, benefiting public finance and citizens (in terms of service quality) as well as private sector actors, such as institutional investors (e.g., closed-end Private Equity funds active in the infrastructure sector), in terms of investment opportunities, returns, and the growth of their role in the market. Making PPP an effective option for public administrations is a necessity, especially in light of the difficulties faced by the public sector, in its various aspects, in financing, designing, and implementing new projects, as well as maintaining existing ones.

The *Global Infrastructure Outlook* has recently estimated a funding gap (the difference between the required investment volume and the currently available amount) in infrastructure assets amounting to 15 trillion dollars (Figure 1).

Figure 1: Increase in the infrastructure gap (\$, tn)



Source: Global Infrastructure Hub – G20 Initiative <https://outlook.gihub.org/>

The present study was conducted by the Centre’s research team, involving the direct participation of practitioners and experts from the field (infrastructural investment funds, legal firms, advisors, industrial entities, representatives of the public administration) who work daily in the market.

A series of semi-structured interviews was conducted, based on a predetermined list of questions provided to the interviewees in advance. These questions were then adjusted during the course of the interview based on the actual personal experiences of the various subjects interviewed. The aim was to identify specific elements that have represented, and continue to represent, constraints on the diffusion of PPP in our country, as well as to make an initial assessment of the reform's effects.

In light of the new Public Contracts Code, this document attempts to assess whether the introduced novelties, especially in the field of 'project finance' and private initiative PPP by private initiative, can, at least in theory, provide effective responses to the issues highlighted by various market operators, and thus contribute to defining a more functional context.

The research concludes with an analysis of some key elements, that go beyond the legislative framework, to ensure the effective development of the instrument.

Definition of Public Private Partnership and market context

The term Public Private Partnership (PPP) refers to all forms of collaboration, not exclusively of a financial nature, between public entities and private operators, aimed at the concrete involvement of private capital and expertise in the implementation of public works for the collective interest.

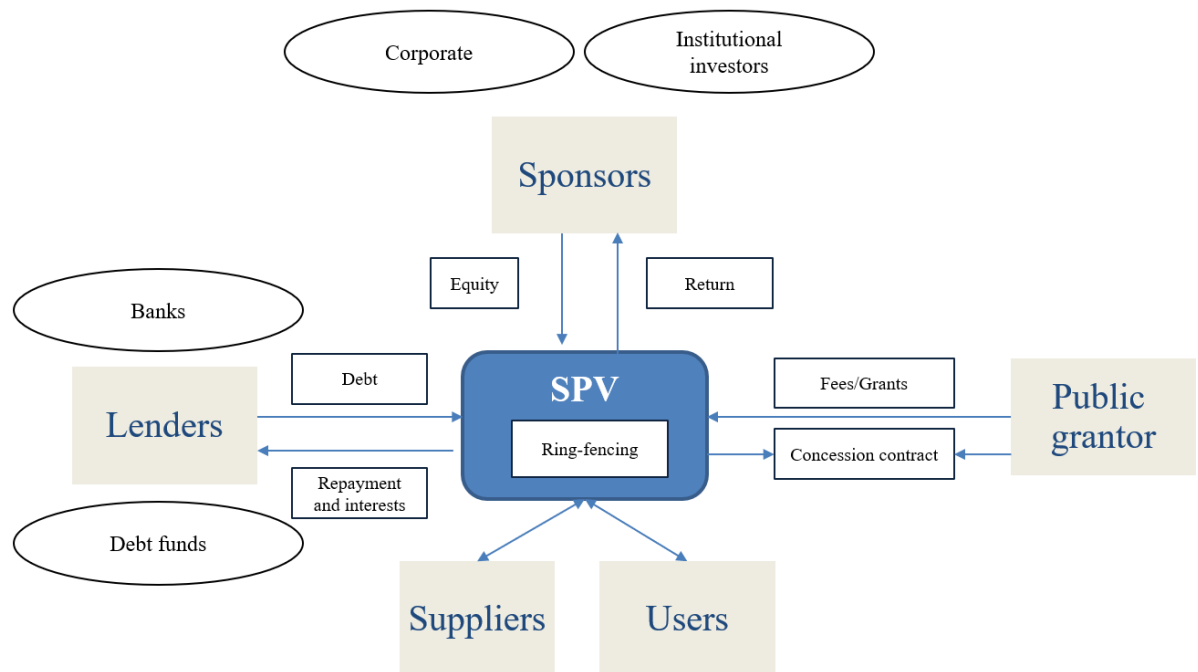
More specifically, according to the definition contained in the new Article 174 of the Public Contract Code, which now contains a specific section dedicated to PPP, Public-Private Partnership is an economic transaction that jointly exhibits the following characteristics:

- a) The existence of a long-term contractual economic relationship between a public grantor and one or more private economic operators with the purpose of achieving a public interest;
- b) The fact that the resources required to cover financial needs should be provided, to a significant extent, by the private entity (also considering the operational risk assumed by the latter);
- c) The planning, management and implementation of the project are in the hands of the private entity, while the public sector defines the objectives and progressively verifies their execution;
- d) The operational risks associated with the project are borne by the private entity.

The instrument thus implies the transfer of certain project risks to the private sector (construction, management and financing) and it is based on the optimal sharing of project risk between the parties. It must offer better Value for Money to the public sector compared to alternative forms of contracting (e.g., procurement).

It is undoubtedly a tool marked by a certain complexity, following rather multifaceted and articulated schemes, requiring specific expertise from all counterparts (Figure 2).

Figure 2: PPP framework

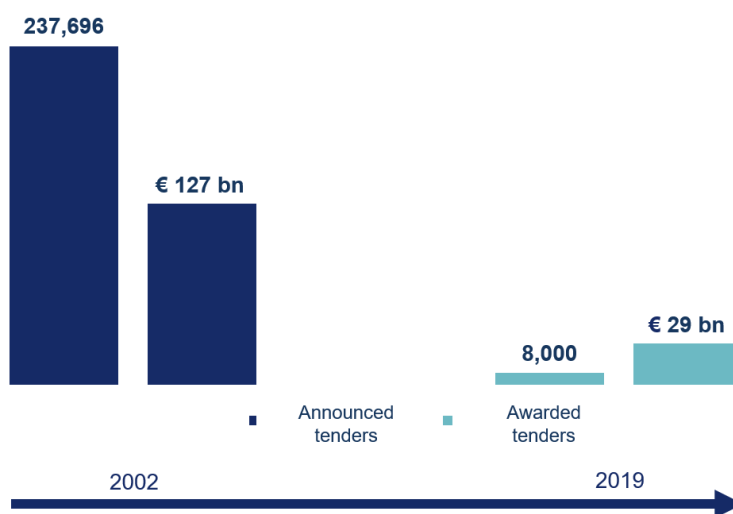


Source: PPP & private capital for sustainable infrastructure and smart cities, Guerini Next (2022)

In Italy, the use of PPP remains relatively uncommon in absolute terms: according to a study by Cassa Depositi e Prestiti (CDP), just over 20% of the public tenders issued have been structured with this model over the last 10 years.

Furthermore, analysing the relationship between PPP announced tenders and those awarded as reported in a study conducted by the National Observatory for Public-Private Partnership of CRESME Europa Servizi, it emerges that between 2002 and 2019 municipalities announced 237,696 PPP tenders for an amount of over €127 billion. However, the number of tenders awarded during that period was just over 8,000, with a total value of slightly less than €29 billion (Figure 3).

Figure 3: PPP tenders announced and awarded in Italy (2002-2019)



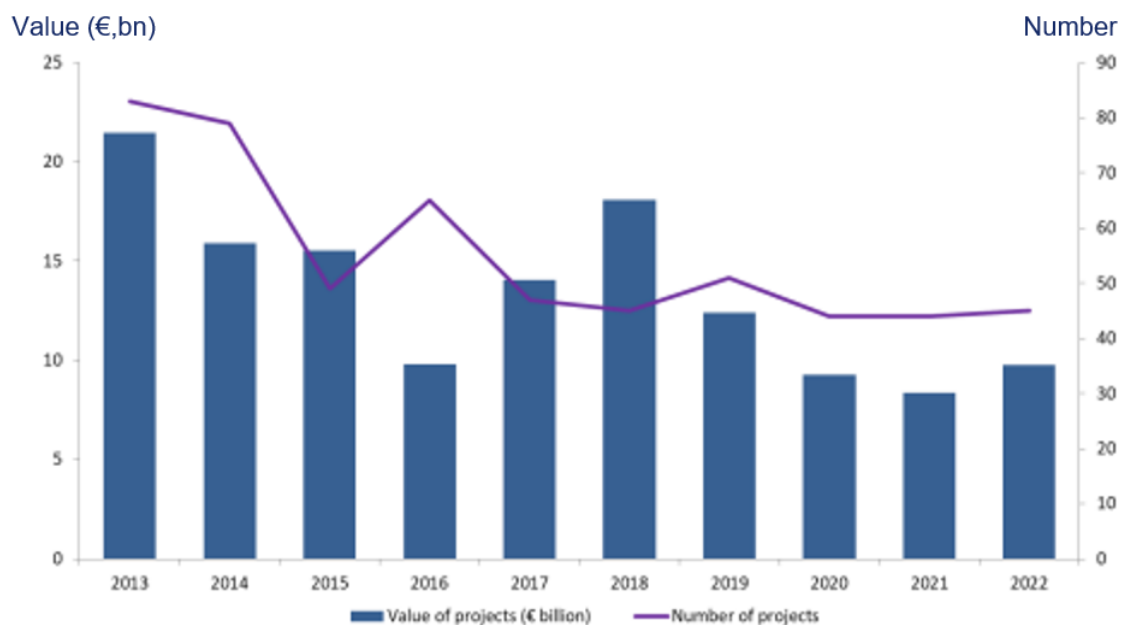
Source: ExSUF elaboration of data by the National Observatory for Public-Private Partnership of CRESME Europa Servizi.

Such a significant difference, although in part it may be due to the limited availability of data regarding the awards (especially for smaller ones), which are more difficult to track compared to tenders, undoubtedly indicates that initiating a PPP requires setting in motion a complex process, characterized by some distinctive elements that must be duly considered.

These findings are confirmed by an analysis conducted by CDP based on CRESME data regarding PPP projects initiated and closed between 2010 and 2019: over 30% of them

ended negatively, with the procedure being discontinued, namely with the cancellation of the tender, non-awarding due to irregularities, or a complete lack of participants in the tender. Furthermore, even by looking at Europe as a whole, EPEC data (Figure 4), with reference to only PPP transactions with a transaction value of at least 10 million euros, confirm the presence of very few projects with significant sizes. Moreover, in terms of the number of transactions carried out, the market has remained essentially unchanged in the last three years (45 transactions carried out annually).

Figure 4: Time trend of the European PPP market by value and number of projects (2013-2022)



Source: European PPP Expertise Centre, 2023.

Limitations of an underused tool

As mentioned, PPP is a complex instrument that requires in-depth knowledge and implies the establishment of a relationship of dialogue and trust between the parties.

The presence of these conditions is not guaranteed, and this delicate mechanism encounters various limitations that affect both the Public Administration (PA) and private entities.

In particular, with regard to the Public Administration (PA), there is often the risk of excessively long timelines between the initiation of a tender process and its award, as confirmed by the data mentioned above. This element poses several challenges for private entities. Firstly, it creates difficulties in constructing an effective project, as there is a risk that it may no longer align with needs or technological changes and/or budget frameworks, thereby rendering the award (and/or the subsequent execution) no longer economically advantageous, namely not suitable for meeting the needs for which it was originally designed.

The time variable becomes even more critical when referring to the involvement of closed-end funds that, given the characteristics and the constraints that distinguish them (a limited and pre-determined investment period, the need to 'close' the fund and reimburse the capital - with a return - to the upstream investors), require specific timeframes.

Another challenge is related to expertise. Despite recent years showing, according to market operators, a significant improvement in the knowledge of PPP rules and the needs of the involved parties among the staff of public grantors, and the introduction of highly skilled professionals, especially in certain administrations with experience and expertise in these matters, there is still a widespread lack of professional figures within the public sector who can serve as suitable counterparts for assessing, managing, and advancing projects of this kind.

In addition to these factors, there are other elements characterizing the public sector that impede the use of PPP. Among them, it is worth mentioning: i) changes in political

leadership, which may have a negative impact on project development and, consequently, on the predictability of cash flows upon which the operation's profitability has been estimated; ii) the excessive fragmentation of the Italian system, particularly in certain sectors such as healthcare; iii) the presence of small municipalities that face greater difficulties in engaging with private entities to structure PPP operations; iv) the presence of public sector personnel who, in some cases, perhaps due to a lack of familiarity with the instrument, slow down or obstruct the progress of processes that require swift action; v) the 'politicization' of some projects, especially in proximity to electoral events; vi) the emergence, in some cases, of resistance from communities to the construction of a project on their territory (a situation often referred to as 'nimby'). The resulting protests are often exploited by politics for their own benefit.

The private entity, and particularly the infrastructure fund considering and evaluating a PPP operation, also faces several significant issues and considerations. In addition to the constraints faced by closed-end funds due to their specific nature, interviews conducted have highlighted problems related to the envisaged returns from PPP operations in Italy, which may result as too low, leading to situations where the conditions for commencing the due diligence processes are not even met, considering the burdens associated with participating in such projects.

Furthermore, at least in Italy, funds are not internally structured to develop and independently present a project – a role that, in our country, is predominantly played by industrial entities as promoters, with several associated limitations. For example, there is a risk of incurring an insufficient or not fully objective financial evaluation, as well as the inability to seize potentially profitable opportunities due to the lack of financial resources required to support the necessary capex flow for such projects. Last but not least, there is an issue affecting the overall Italian market for so-called alternative funds. Institutional investors, such as pension funds and insurance companies, allocate a very limited portion of their investments to private capital instruments. According to AIFI and FranceInvest data for 2022, institutional investors in Italy only allocated around €450million to the infrastructure asset class, against the €8 billion in France.

The new Public Contract Code: an opportunity to be seized

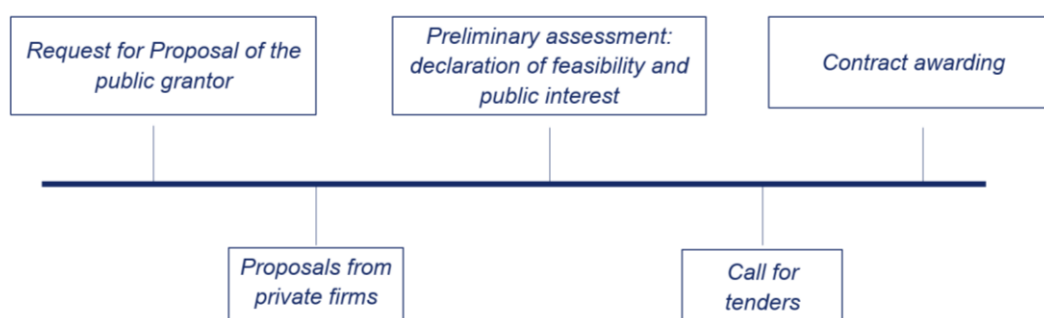
The reform of the Public Contract Code, which came into effect on July 1, 2023, has dedicated the entire Book IV to PPP, with the aim of streamlining and increasing its use by public administrations and economic operators (industrial and institutional investors).

The Code makes a distinction between a process activated by the exclusive initiative of the public grantor, and the 'project finance', the model upon which this report has focused.

Among the most significant innovations, first and foremost, is the possibility for the public grantor to encourage private operators to take the lead in PPP initiatives (Article 193) through a notice of Request for Proposal containing the main technical and risk allocation requirements (Figure 6).

The documentation required to respond to the notice will, therefore, be produced by the private entity, with a certain degree of autonomy. In this regard, the institutionalization of the solicitation phase can serve as an incentive for private entities to take a proactive role in structuring PPP proposals for large-scale projects. In the absence of a formalized public call for proposals, such projects were difficult to prepare since they involved significant project efforts and, in practice, risked not to be aligned with the actual public sector needs.

Figure 5: Stages of a private initiative PPP project



Source: authors' personal elaboration

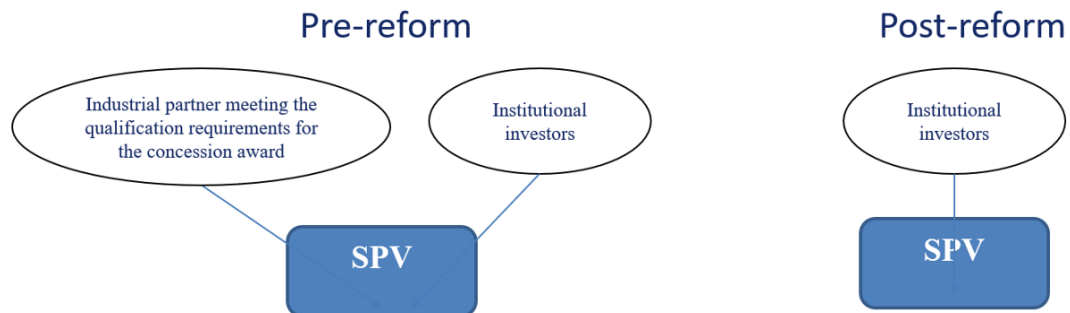
This leads to an initial finding: while, on one hand, the burden required by a notice of Request for Proposal is lower for a public grantor compared to the documentation necessary to directly prepare a tender for concession, on the other hand, public grantors will need specialized expertise to assess the public utility of proposals that may be diverse and not immediately or easily comparable. This pre-assessment phase, preceding the declaration of feasibility and public interest of the PPP proposal, is, therefore, of great importance.

In general, the public grantor plays a key role: central purchasing bodies acting as consultants to poorly organized public grantors, a public coordination hub to address competency gaps, a proactive and confident approach toward a 'buy' logic as opposed to a 'make' logic, education and awareness programs regarding the instrument, the adoption of incentivization mechanisms, the sharing of successful cases, and standardization of procedures; these measures, coupled with the need to effectively delineate responsibilities for individual officials, are among the potential avenues for accelerate the processes of public grantors and contributing to the dissemination of PPP.

At the same time, private entities shall avoid preparing proposals that challenge fundamental principles or diminish the public interest represented in the notice of Request for Proposal. They should remember that the PPP instrument must always be viewed as an operation that entails assuming entrepreneurial risk (not exclusively projects with availability fees guaranteed 100% by the authority) and must be aimed at fulfilling the citizens' needs by delivering an efficient service, with the actual transfer of risk inherent in the instrument, which sets it apart from a simple procurement.

Regarding the possibility for private operators to take the lead in PPP initiatives, the reform permits any private operator, including institutional investors, to independently submit proposals without the need for consortium arrangements in the preliminary phase with industrial operators possessing the necessary technical qualifications (as required before the reform). There's also the possibility to manage sub-contracts at a later stage (Figure 6).

Figure 6: SPV Governance in the proposal submission phase, pre and post reform



Source: authors' personal elaboration

The introduced novelty may assume a fundamental role in lightening the initial governance phase, especially when the public utility has not been established yet. Therefore, the entire structuring of the future SPV's (Special Purpose Vehicle) governance, which is economically and time-consuming, is delegated to a phase in which the investor has at least the declaration of public utility and, consequently, the pre-emption right. Additionally, the sub-contract can be directed to companies that are not in the SPV's ownership structure, further simplifying the project governance. This simplification can have a positive impact on the project's guaranteed return, bringing it closer to an investor's target IRR.

The objective of the new rules to provide more autonomy to the financial entity implies a second key consideration: the presence of institutional investors equipped to fully grasp the innovations contained in the regulations.

There is, in fact, a need for structured players who possess in-house expertise (engineering and administrative) useful for preparing PPP proposals and the ability to adequately assess risks, limiting reliance on external consultants, also with the aim of maximizing their target return. In any case, it is plausible to think that the financial entity will need some key technical partners (for the design and implementation of the project) from the beginning to define a solid and credible PEF (Project Execution Framework). In this sense, the

absence of an obligation to form a consortium in the project company can facilitate efficient collaboration among these various actors.

At the same time, more structured institutional investors will be more motivated to independently submit proposals - aimed at securing their pre-emption right - which would subsequently be carefully adjusted after discussion with construction and/or operation entities.

In general, the instrument should be designed in such a way that the project company assumes the asset management risk and is remunerated based on certain qualitative criteria, with adequate tools to intervene with service providers (if they do not perform correctly) and replace them to bring the service back to the concession standards.

On this point, it shall be fundamental to clarify certain elements, especially concerning the possibility of changing sub-contractors. The regulations, in fact, seem to indicate a prohibition on using sub-contractors different from those indicated in the proposal phase. If confirmed, this would certainly represent a significant limitation to the flexibility with which the project is managed.

Leading Role for PPP in the Future: What Needs to Change Besides Regulations

The framework of the main innovations introduced, although with elements that still need clarity and practical validation in the field, outlines a context in which the legislator's intention to create favourable conditions for the PPP instrument to finally play a prominent role in the Italian infrastructure financing landscape is evident.

That being said, there remain a series of additional limitations that the entire Italian system must address to ensure that the well-designed and written regulations can then find practical implementation.

With the goal of contributing to the debate and reasoning among ecosystem stakeholders, below are some of the most critical elements and points of reflection that emerged from the interviews.

Regarding the public player, it becomes crucial to reduce the timeframes for the award of tenders, as this would enable the adherence to the economic and financial assumptions estimated during the design phase, ensuring its sustainability. Additionally, as mentioned earlier, delays do not align well with the typical investment horizons of closed-end funds, characterized by a limited and predetermined investment period. Uncertain timelines and the risk of the absence of bidders have a negative impact in terms of wasted resources and a lack of confidence in the possibility of participating in similar projects in the future.

On this topic, it might be useful to consider standardizing some phases of the process, minimizing differences between various administrations, and increasing technical expertise within the public administration.

In this regard, the role central administrations, such as the DIPE (Department for Economic Policy, Planning, and Coordination), and significant institutional actors like CDP – which have already positively engaged in this direction – can play a crucial role in providing technical support to administrations. They can guide administrations through the various project phases and contribute to the emergence of common and consistent practices. This could be accompanied by a more specific exchange of experiences between municipalities or regions at defined intervals to facilitate the sharing of best practices and improve coordination. It would also be significant to consider the possibility of introducing incentive mechanisms – not just defining them – for those structures that prove to be particularly effective in the practice of PPP.

Another challenge that emerged concerns the difficulty smaller entities face in initiating certain types of projects. In this regard, the potential positive role played by central purchasing bodies shall be highlighted. A PPP operation is a resource-intensive process for all involved actors in terms of timelines, resources, and necessary expertise (phases of design, bidding, due diligence, financing, etc.). Additionally, the lack of economies of scale, typical of smaller projects, may imply that PPP is economically less attractive compared to

other available models, such as traditional procurement. In this sense, potential central purchasing bodies and intermediate technical units would also allow for the consolidation of projects from multiple local authorities in a collaborative, more efficient approach that reduces waste and enhances the effectiveness of services provided to the population.

If public administrations have various areas in which they need to improve and to be more effective, institutional investors, to whom the new regulations call to take the initiative and act as protagonists, also have limitations and weaknesses that should be emphasized and addressed to avoid rendering the introduced changes futile.

First and foremost, investors should have commercial capabilities that can identify the real needs of the public grantors. In this regard, collaboration with an industrial entity that possesses this asset and can take on the role of a builder or a technological partner/project operator becomes relevant.

Furthermore, institutional investors typically look for projects with a minimum investment ticket size that is higher than many PPPs available in the Italian market. In this sense, establishing a holding company that capitalizes SPVs representing various initiatives can help achieving a critical mass of projects that ensures risk diversification, even geographically, and a total capex amount that is of interest to institutional investors (both equity and debt).

Investors should always keep in mind when dealing with the public counterpart that the resources allocated through PPPs are intended to create a good or service for the community. This objective can be achieved through smaller-scale projects or capex while still having a significant impact on citizens.

Finally, international infrastructure operators, particularly in certain markets like the UK, Canada, and Australia, have more significant resources than those operating in Italy. This enables them to be more specialized, even in a technically complex market like PPPs. Therefore, collective action is needed to ensure that Italian infrastructure funds can raise more funds for investment, including through the PPP, in an asset class that offers

relatively stable long-term returns and aligns well with the investment needs of entities such as insurance companies and pension funds.

In general, in the relationship between the public and private sectors, it is important for both parties to increase their awareness of the possibilities and advantages of structuring their collaboration in the form of a PPP.

While, as emphasized, the public sector needs to enhance its expertise and become more efficient in its processes, the private actor also shall understand the constraints within which the public counterpart is required to operate.

It is ultimately a path of mutual understanding. Over time, trust needs to be established, bearing in mind that if this trust were to be eroded - for example, due to an excessive extension of the proposal by the private party, the definition of mechanisms or logic that run counter to the spirit of the public entity, or overly extended timelines - not only could an individual project fail to materialize, but it could create a situation of general uncertainty, if not mutual distrust, with repercussions on potential future collaborations. In conclusion, it is important that the discussion about PPP, which is often viewed on an international scale either as a remedy for all problems or as a failure of the public sector abdicating its role in favour of the private sector, is framed within a rational discussion. The instrument has its potentials and limitations, as this text has sought to illustrate, and it requires a joint effort from all stakeholders to ensure that PPP can be firmly established as one of the alternatives a modern state, in its various components, can employ. This is especially important in a situation characterized by limited public resources for financing new infrastructure or maintaining and renewing existing ones.

The rules introduced by the new Public Contract Code present an important opportunity to rekindle dialogue among stakeholders, reduce the distances between the parties involved, and work together to promote the use of PPP.