TOWARDS A MODEL FOR GOAL SETTING AND NEGOTIATION IN PUBLIC PRIVATE PARTNERSHIPS

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Abstract

In Australia, Public Private Partnerships (PPPs) are a relatively new concept to project finance. While there have been many successful infrastructure projects undertaken through PPPs, there are other PPP projects that have been fraught with problems. PPPs such as the Spencer Street Railway Station redevelopment in Melbourne and the Cross City Tunnel in Sydney renewed debate among professionals and academics on both the merits and the future direction of PPPs.

PPPs in project finance bring together two disparate organisations with distinctly different goals as project sponsors. Such an arrangement requires the project sponsors to constantly strive to achieve common goals. Therefore, the success of PPPs depends upon, *inter alia*, the process of goal setting and negotiation by the project sponsors to meet their respective goals and to achieve the best possible performance outcome.

Works describing the structuring of project finance and the use of the PPPs are increasingly common (Esty and Christov, 2002, Esty, 2003, Finnerty, 1996, Nevitt and Fabozzi, 2000, Yescombe, 2002). Nonetheless, the authors have not located any works focusing on the goal setting and negotiation issues in PPPs. This paper takes a first step towards addressing this deficiency by presenting a model for goal setting and negotiation in PPPs. This is followed by a review of the literature in each of the key areas of the model that influences goal setting and negotiation in PPPs: strategic factors in project finance, public sector goals and private sector goals. It concludes with the identification of the key research questions emanating from the model.

Keywords: Project Finance, Public Private Partnerships, Goal Setting, Negotiation.

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1 INTRODUCTION

Public Private Partnerships (PPPs) in project finance bring together two disparate organisations with distinctly different goals as project sponsors. Project sponsors under such arrangements strive to achieve a symbiotic relationship. Therefore, to a large extent, the success of PPPs depends on goal setting and negotiation by the project sponsors to meet their respective goals and achieve the best possible performance outcome.

In Australia, State governments in Victoria and NSW were the first to push for PPPs. As of 2004, approximately 170 PPPs had been completed in Australia (AFR, 7 May 2004) with a similar number of PPP projects then under consideration for development. However, the success of many PPP projects in the past has been overshadowed by the problems faced by others failed projects. The incidents have renewed debate among professionals and academics on the merits and future direction of PPPs.

The size of the project finance market reflects its importance in the field of finance and business. Professional project finance literature is replete with prescriptive advice on how PPP projects should be structured and the merits of using PPP in project finance. However, the advice given is, for the most part, unsubstantiated by theoretical investigation and lacking as a basis for a more scientific approach to the management of project finance decision making in PPP.

Of particular concern is the issue of how the divergent goals of the public and private sectors in PPPs can be accommodated. This paper takes the first step by presenting a model for goal setting and negotiation in PPPs. It begins with the presentation of the model to support the inquiry into the influence on the process of goal setting and negotiation in PPPs. It first looks at the literature pertaining to strategic project finance factors, public sector goals in PPP, and private sector goals in PPP that have a significant impact on the process of goal setting and negotiation. Discussion of the model is then directed at the key decision parameters in the process of goal setting and negotiation in PPP projects. The paper concludes with an identification of key research questions in each of the three areas affecting PPP negotiations.

2 THE MODEL

The model for goal setting and negotiation in PPP projects is presented below in Figure 1. The independent variables in the models are (1) strategic factors in project finance, (2) public sector goals in PPP projects and (3) private sector goals in PPP projects. These independent variables are deemed to influence the process of goal setting and negotiation in PPPs (the model's dependent variable).

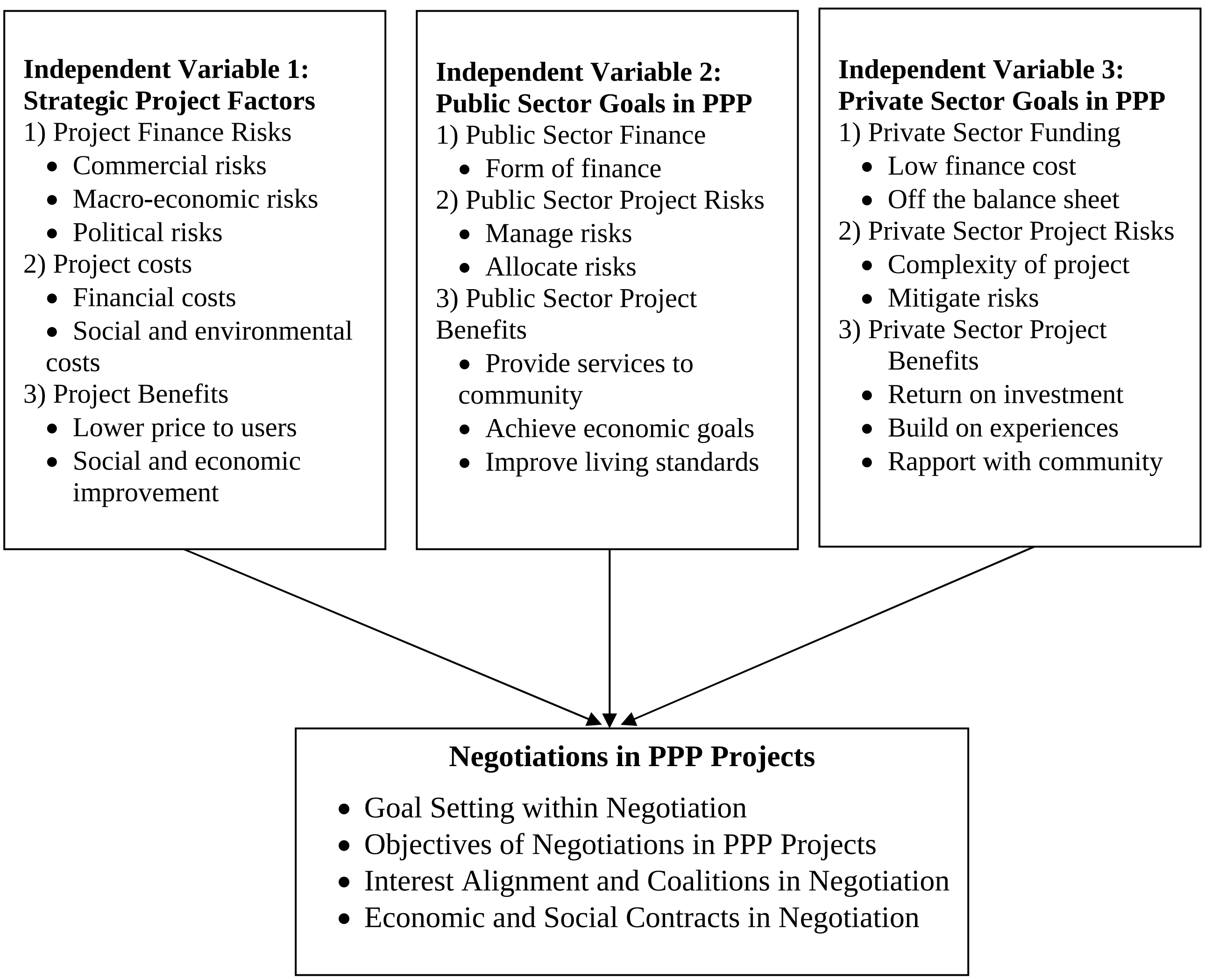

Figure 1: Project Finance Decision Model in PPP Projects.

3 STRATEGIC FACTORS IN PROJECT FINANCE

The strategic factors in project finance can be broadly classified into three main categories: project finance risks, project finance costs and project finance benefits. Though these factors have been variously discussed in project finance literature, its integration into goal setting and negotiation by the project sponsors has not been fully researched. Understanding how these factors influence goal setting and negotiation can provide insight as to why some PPPs succeed while others fail.

3.1 Project Finance Risks

Yescombe (2002, p 137) categorizes the wide array of project finance risks into three main types: commercial risks, macroeconomic risks and political risks. Reviewing and evaluating these risks allows better allocation which is based on who is best able to control or manage them (Bing et al., 2005, Brealey et al., 1996).

Commercial risks, also commonly refer to as project risks, are inherent in the project and the market in which it operates. Based on Yescombe (2002), the main areas of commercial risks are commercial viability, completion risk, operating risk and revenue risk. The first step in establishing the extent of commercial risk is to determine how commercially viable the project is (Allen, 2002, Yescombe, 2002). This encompasses a broad understanding of the nature of the project as well as the socio-economic and political environment under which the project operates. Secondly, there is completion risk. This is a crucial factor to the success of the project, depending on whether the contractor is able to complete the works on time. How issues such as site acquisition and access, necessary permits and third party work arrangement are managed, as well as the environmental constraints the project may face are pivotal to the success of the project. Thirdly, after the project is completed, operating risk such as technology, general operation of the project and operating cost overruns affects the long term operations of the project. The technology used during the operation if based on an existing technology could become obsolescent or if new and untried, could pose problems during operations. Finally, there is the risk of whether the project company can earn sufficient revenue to service its operating costs and debt and, also to provide an adequate return for investors. This risk is linked directly to volume risk and price risk.

The second category of project finance risk is macroeconomic risks, also known as financial risks (Yescombe, 2002). These relate mainly to inflation, interest rate and currency exchange rate movements – relating to the economic environment in which it operates and not to the project itself.

The third category of project finance risk is political risks and these generally fall into two main aspects: investment risk and change of law risk (Yescombe, 2002). Investment risk covers risk associated with currency convertibility, transfer and exchange, expropriation and internal political instability such as civil unrest, sabotage or terrorist attack. Change of law risk, which includes any breach of contract, has a much wider application especially in developing countries than developed countries. This happens when there is a need to incorporate new social, environmental or political requirements to an industry or the society. A breach of contract arises due to changes to support and concession agreements.

3.2 Project Finance Costs

The second strategic factor that influences goal setting and negotiation in PPP projects is project finance costs. Because it is common for large-scale infrastructure projects to cost over $500million, the high financial costs limit the number of potential project sponsors. The financial cost of an infrastructure which the project sponsors consider to be the fundamental issue in project finance decision depends on the size of the project. This is not just the physical magnitude, but size also hinges on the degree of difficulty and the technology used in implementing the project.

Apart from the financial cost, project finance costs also include social and environmental costs. Developing large-scale infrastructure projects have far reaching social and environmental impacts on the communities to which it will eventually provide services. The costs on the social and environmental externalities are equally important considerations. These must be evaluated and negotiated to reflect the changing community expectations about the performances and responsibilities of the project sponsors.

Academic and managerial researches in large-scale infrastructure projects have generated great interest because the size of the projects provides the scope to unravel the various complex issues in project finance. Esty (2002) maintains that research on project finance goes beyond academic interest. The size of the project means that sponsors have the opportunity and the economic incentive to make careful, value-maximising decisions due to the significant money at stake.

3.3 Project Finance Benefits

The third strategic factor that influences goal setting and negotiation is the project finance benefits. Firstly, since the revenue from the projects will be on-going over several years, the users do not pay a large amount when they use such facilities in the initial years. In addition, any economies of scale that the project experienced during construction resulting in cost savings would be translated into lower fee being charged to the user.

Secondly, there are the indirect and non-commercial benefits to the community and the economy as reflected in the social and economic enhancements these projects bring about. Development and successful completion of these projects create jobs for the communities and elevate social and community living standards. It also helps to develop the financial service sectors of the economy especially the capital market because of the significant amount of debt and equity finance require for the projects. There will be mobilisation of skilled work force into the economy and incentives for innovations through the use of new technologies.

The benefit of the development of large-scale infrastructure projects is best summed up by Richard Samans, Managing Director of the World Economic Forum’s Global Institute for Partnership and Governance at the World Economic Forum in Geneva (2005):

> Many public-private partnerships are new and untested and some of them are likely to fail. Yet, these partnerships offer an important new approach that has the potential to drive innovation, improve governance, raise living standards and provide opportunity to millions of people. They deserve continued support, engagement and evaluation from business leaders.

4 Public Sector Goals in PPP Projects

The public sector goals in PPP projects can be discussed under three main headings: to increase efficiency in public sector finance, to manage project finance risks and to extend project finance benefits to the community. It is posited that these goals influence negotiation in PPP projects.

4.1 Public Sector Finance

The first public sector goal is to ensure efficient use of public fund. Whether these projects can be funded as much from revenue sources, or through borrowing from the private sector, or through partnerships with the private sector, the public finance policy is to ensure that these projects achieve value for money in the public interest (Bing et al., 2005).

4.2 Public Sector Project Risks

The second public sector goal is to manage the project finance risks as well as it possibly can or allocate the risks to a third party. There are the risks that planned levels of service delivery are not met or delayed, financial loss, fraud, waste or inefficiency. There are also risks of missing the opportunities to deliver services in new ways, project cost overruns, undesirable impact to the environment, inflation exceeding the acceptable level, and stability in the exchange rate (Yescombe, 2002, Tinsley, 2000). Wherever possible, the public sector aims to reduce the level of risks by allocating as much of these risks as possible to a third party who is best able to control, manage or mitigate those risks (Tinsley, 2000, Esty, 2002, Yescombe, 2002).

4.3 Public Sector Project Benefits

The third public sector goal is to consider the project finance benefits. The benefits of large-scale infrastructure projects arise from the responsibility the communities place on the public sector. Musgrave, *et al* (1989) note that most of these projects are broadly classified as "social goods and services" which are deemed to be the responsibility of the public sector. Therefore the public sector has to firstly ensure that the benefits of such projects should be "felt" by the entire community as long as they want to access these facilities. If left to the private sector, it can result in the social, economic and environmental benefits not being felt fairly and enjoyed by a broader cross section of the community.

Secondly, PPPs enable the public sector to accelerate the development of infrastructure projects for the benefit of the community (Thomson and Goodwin, 2005). Left entirely to be developed by the public sector, these projects may be delayed due to a lack of funding or expertise and experience. In the short term, the primacy for public sector involvement in PPPs is to align such development with its overall strategic economic goals (Phillips et al., 2004) such as business expansion and job creation but in the long term, PPPs parlay the creation of “synergy that helps attract other private sector development” (Phillips et al., 2004). PPPs in developing countries are especially seen as attractive in terms of their capacity to achieve the transfer of technological knowledge to local enterprises (Bing et al., 2005).

5 Private Sector Goals in PPP Projects

The private sector goals in PPP projects can be classified into three main areas: to secure funding at as low a cost as possible so as to increase profit, to manage project finance risks without compromising profitability and to attain financial and non financial project finance benefits.

5.1 Private Sector Funding

Firstly, the ability of private sector to raise funds through various financial institutions where there is a large source of equity and debt in the money market, commonly results in lower costs. Large-scale infrastructure projects by design usually employ high leverage because debt is cheaper than equity due to the tax deductions on interest. In addition, lenders are willing to accept a lower return for the lower level of risk in project finance because the risk is spread among the various parties. How the financial structure is finally established will determine the success of the projects (Nevitt and Fabozzi, 2000).

Secondly, project finance generally allows the project sponsor to keep the debt off the balance sheet. This is seen as beneficial to a company’s position in the financial markets because this does not compromise the project sponsors other commercial business.

5.2 Private Sector Project Risks

The first project risk faced by the private sector depends on the complexity of the project. Because PPP arrangements allow public sector to allocate project finance risks to the private sector, the public sector will transferred as much of these risks as possible to the private sector if the project is more complex. The private sector while accepting these risks, will investigate how best to manage them (Estache and Strong, 2000). Explicit information about risks to be allocated is considered a positive factor by participating private sector (Bing et al., 2005) because the extent of risks is known and can therefore be priced. In an attempt to mitigate some of the more difficult risks, the private sector will also explore how to involve the public sector should these risks become insurmountable.

Moreover, there is the opportunity to reduce project risks further by virtue of the working group mechanism because the partnership with the public sector is a tangible expression of the public sector commitment to the project and its success. The concessions and support given by the public sector as part of the partnership, some of which can continue through the operational phase, increase the likelihood of success and higher profits (Estache and Strong, 2000).

5.3 Private Sector Project Benefits

There is no doubt that the private sector is motivated by financial benefit in PPPs. The level and extent of this benefit will depend on the amount of risk being transferred to them and the ability to employ its resources most efficiently. There is a further financial benefit in that although the investors may need to compete for the right to develop the projects initially, once awarded and successfully completed, generally do not have to participate in a competitive market for other related projects which can yield a greater stream of profits (Roseman, 1999, Bing et al., 2005).

There are non-financial benefits that motivate the private sector into PPP projects (Bennett et al., 2000). Firstly, since most of these projects require specialist contractors, the private sector gets the opportunity to forge alliances with international contractors and access modern technology (Estache and Strong, 2000). On completion, the private sector can showcase the projects to enhance its image.

Secondly, the private sector will use their involvement in PPPs as leverage to develop an innovative and proactive dialogue with public sector on matters of common environmental concerns (Estache and Strong, 2000). PPPs provide the opportunity for the private sector to align more closely with sustainable development, eco-efficiency and public participation. The ability to manage the project with minimum social inconveniences and environmental disturbances will endear them to the public. Private sector likes to project the image of a responsible corporate citizen. The profit that the private sector makes from the project will therefore not be seen as greed to the public.

6 Decision Parameters in the Project Finance Decision Making

The independent variables posit to influence goal setting and negotiation in PPP projects provide the framework for project finance decision in PPP projects. Finnerty (1996) recognises that PPPs "are governed by negotiated agreements that specify public and private responsibilities, impose public regulation of safety, require quality of service, and often restrict user fees (or profitability)". Therefore, the strategic context of negotiation between public and private sectors is fundamental to partnership viability (Ghere, 2001). This paper intends to address four key parameters in project finance decision making that are posited to determine the success of the PPP projects: goal setting within negotiation, objectives of negotiation, interest alignment and coalitions in negotiation, and economic and social contracts in negotiation. Each of these parameters is discussed below.

6.1 Goal Setting within Negotiation

Studies on public and private sector goals in PPP projects, discussing how adherence to these goals influences each other, have yet to adequately assimilate into the general literature of project finance. To do so, there is a need to understand how these respective goals influence goal setting in negotiating within the partnerships. This requires the understanding of the mechanism by which goals operate since this is the basis of goal setting theory. Locke and Latham (2002) state that:

> The focus of goal setting theory is on the core properties of an effective goal. These properties are specificity and difficulty level; goal effects at the individual, group and organisation levels; the proper use of learning versus performance goals; mediators of goal effects; the moderators of goal effects; the role of goals as mediators of other incentives; and the effect of goal source.

Therefore a review of the goal setting theory will enhance the understanding of the core properties of public and private sectors goals in PPP projects. They will provide the basis for the application of a general framework into investigating goal setting and negotiation so as to allow for a more complete insight into the project finance decision making. It will also demonstrate how goal setting and negotiation can help achieve greater performance for all parties concerned.

Bennett, *et al* (1999) contend that the strong foundations for PPPs are based on complementary goals and an enabling regulatory and political environment. Partnerships can only work to the extent that the goals of the different parties are mutually compatible, understood and accepted by all. In addition, Bennett, *et al* (1999) stress that PPPs need legislative, administrative, political and social environments to support and encourage the development of these partnerships. To achieve a successful working partnership, both sectors must focus on broad complementary goals and resolve conflicting goals during goal setting and negotiation. These dual processes play a key role in shaping the project finance deal of PPP projects as they attempt to bring into harmony the goals of the project sponsors and address wider issues.

Although the concept of goal setting has been discussed within the context of negotiation, Zetik and Stuhlmacher (2002) note that the complexity of goal setting theory has yet to be thoroughly tested so as to fully integrate the unique characteristics of negotiation. Thus, to further understand goal setting within negotiation, a review of the literature that bridges goal setting and negotiation is needed. Comprehensive reviews of research on goal setting (Locke and Latham, 1990, Tubbs and Steven, 1991) provide compelling evidence of the effectiveness of goals to increase performance during negotiation.

Firstly, goal setting theory has empirically shown that negotiators with distinct goals consistently achieve higher outcomes than negotiators with low or no goals (Latham and Locke, 1979). Zetik and Stuhlmacher's (2002) study gave further credence to this hypothesis that has received strong empirical support. They observe that the relationship between goals and negotiation performance is moderated by symmetry of opponents' goals and level of interaction between opponents. When there are asymmetrical goals, competition can be dysfunctional in terms of performance (Campbell and Furrer, 1995).

Secondly, the more difficult the goal, the higher is the level of performance (Knight et al., 2001, Locke and Latham, 1990). In their study, Knight, *et al* (2001) found that difficult goals consistently motivated teams to choose strategies with higher levels of risk, which in turn led to better performance. However, higher strategic risk may not always lead to better performance because risk also implies a greater chance of failure. Knight, *et al* (2001) conclude that negotiation success depends heavily on the strategies negotiators use to navigate the relationship of goals, incentives and efficacy to strategic risk, tactical implementation and performance. Notwithstanding this, research has generally found that the level of goal difficulty has a significantly positive impact on goal performance (Zetik and Stuhlmacher, 2002). Therefore, difficult goals and incentives increased commitments to achieve higher performance.

Thirdly, research in goal setting theory generally supports the view that specific, challenging goals, when considered independently, produce less variance in performance as compared to vague or "do-your-best" goals (Locke and Latham, 1990, Northcraft et al., 1994). Huber and Neale (1987) provide evidence that in an integrative bargaining task, negotiators who were assigned challenging and specific goals performed better. These integrative effects of goal setting and negotiation are further supported in a separate study by Polzer and Neale (1995) when they found that:

> The effects of goal setting on negotiator performance in bargaining task have been found to be consistent with results in outer contexts. In a negotiation, externally determined, specific, challenging goals set prior to negotiation have been shown to produce higher performance at both the individual and dyadic levels when compared to negotiators given easy or non-specific goals. This effect occurred primarily because negotiators with specific, challenging goals were more likely to search for and find integrative solutions, in which outcomes on issues of lesser value were exchanged for outcomes on issues of greater value.

6.2 Objectives of Negotiation in PPP Projects

The second decision parameter is to establish the objectives of negotiation in PPP projects. Because negotiation is characterized by interdependence between two or more parties who must work with one another to resolve conflicting goals (Thomas, 1992), negotiation can either be distributive or integrative. Since negotiation is to resolve conflicting goals and contentious issues, solve new problems that arise during the construction and operational phases of the project and help all parties to attain higher performance outcomes, negotiation can only be effective if it is integrative rather than distributive (Zetik and Stuhlmacher, 2002). In a distributive negotiation, resources are fixed and limited. The goals of one party and the attainment of those goals are in direct conflict with the goals of the other party. It has the effect of one party winning and the other losing (Zetik and Stuhlmacher, 2002). Integrative negotiation, on the other hand, can occur when there are opportunities for both parties to win and negotiators seek options that reconcile the needs of both parities and produce solutions of high performance benefits (Zetik and Stuhlmacher, 2002). Given that distributive negotiators are primarily focused on their individual goals while integrative negotiators are expected to be concerned with successful outcome for both parties, the symbiotic relationship between the public and private sectors require both parties to maintain an integrative negotiation.

6.3 Interest Alignment and Coalitions in Negotiation

The third decision parameter is interest alignment and coalitions during negotiation among the project sponsors. In multiparty negotiations such as the case of PPPs, both the public and private sectors will need to be cooperating enough to reach mutually acceptable agreements while simultaneously be competing enough to satisfy individual interests. These interests may align with others' interests in ways that are distributive, integrative or compatible (Polzer et al., 1998). Multiparty negotiations are complex social interactions because of the multiple sets of preferences that must be considered in fashioning agreements and the interpersonal dynamics that grow increasingly complicated as more people interact (Neale and Bazerman, 1985). An especially important source of complexity in multiparty negotiations is the inherent potential for coalition membership to influence the negotiated outcomes (Polzer et al., 1998). The public and private sectors, each with disparate goals, seek to align their interest and establish alliance in order to achieve a higher performance outcome that will determine the project finance deal.

6.4 Economic and Social Contracts in Negotiation

The fourth decision parameter is to review the negotiation of economic as well as social contract. Economic contract explicitly records agreements in a partnership that avoids legal suits at a later stage. Social contract or the "spirit of the deal" is not mentioned or discussed but implicit in the deal and therefore has to be openly discussed and negotiated so as to eliminate the different assumptions and expectations that are not communicated explicitly (Fortgang et al., 2002). Negotiating the social contract centres on expectations and provides insights on what is not legally mentioned or discussed.

Even where the economics of a contract are compelling, there may not necessary be a meeting of minds among all parties and the social contract can get short shrift. Unforeseen clashes between economic and social contracts may push the negotiating parties apart. It is critical that during negotiation, the economic and social contracts are independently strong and reinforce each other (Fitzgerald, 1996, Fortgang et al., 2002). The importance of both the economic and social contracts in the negotiation between public and private sectors is imperative to the success of the partnership.

Conscious efforts to shape the social contract and discussions on what and how the parties expect to communicate over a period of time can help stave off later problems. Straightforward practices such as creating shared operating principles that govern confidentiality, information exchange, the creation and use of intellectual property, and dispute resolution systems can build needed trust and stability. This gives the partnership the proper launch (Fortgang et al., 2002).

It will be erroneous to take the social contract, *prima facie*, as unwritten and purely subjective as opposed to the economic contract which is written and objective. Properly dovetailed all aspects of the social contract must be embodied in mutually reinforcing economic agreements (Fitzgerald, 1996, Fortgang et al., 2002) so that there is a complementary fit between the economic and social contracts. This is the key element in negotiation among the various project sponsors in any PPP projects.

7 Conclusion

Goal setting and negotiation posit to play a critical role in determining the project finance deal of PPP projects. Little or no research has been undertaken to investigate goal setting and negotiation in either project finance or PPP projects and how it helps project sponsors to attain optimal operating and financial structures within PPP projects. This paper is a first step to address this deficiency and serves as a call for more work to integrate goal setting and negotiation into project finance and PPP literature.

The first objective of the study is to examine how strategic factors in project finance influence PPP negotiations. Investigation will focus on how and why project finance risks, project costs, and project benefits each impact negotiations in PPP projects, in terms of negotiation objectives, goal setting within negotiations, interest alignment and coalitions, and economic and social contracts.

The second objective is to examine the effects of public sector goals in PPP negotiations. Investigation will focus on how and why public sector funding, public sector project risks, and public sector project benefits influence PPP negotiations along the lines detailed above.

The third objective is to examine the effects of private sector goals in PPP negotiations. In this regard, investigation will focus on how and why private sector goals in the alternative forms of finance, private sector project risks, and private sector project benefits impact upon the various forms of PPP negotiations.

Pursuing the above three research objectives will enable the development of new, richer descriptions of the factors impacting PPP project negotiations. Ideally, these descriptions will be developed both longitudinally within project negotiations and across PPP projects of differing scope and complexity to more fully uncover the key themes surrounding PPP project negotiations.

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