

## THE PRIVATE SECTOR AS A REGULATORY TOOL FOR PUBLIC PRIVATE PARTNERSHIPS

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### I INTRODUCTION

Using private enterprise to provide public services is not a new phenomenon. For example, during the reign of Elizabeth I, joint stock naval enterprises flourished. These were enterprises financed jointly by the Crown and syndicates of private subscribers investing for profit.<sup>1</sup> However, structural mechanisms involving a mixture of private and public characteristics have recently been given a new lease of life as the public sector has striven to develop more effective ways to deliver traditional public services.

The question naturally posed by the use of public private partnerships ('PPPs') for the delivery of public services is whether the introduction of the private sector enhances or impedes accountability of the public sector. As a way of answering this question, the paper explores two related themes:

- whether the current mechanisms regulating corporate businesses provide an adequate source of accountability; and
- whether the profit and cost incentives of the private sector provide mechanisms for accountability.

The paper develops first by considering what the term 'accountability' means and then explores current corporate accountability requirements, the incentives for business to voluntarily disclose information and the relevance of each of these issues for public accountability. The paper concludes that it may be unwise to believe corporate accountability is a ready substitute for public accountability and, consequently, has limited usefulness as a regulatory tool for PPPs.

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1 James D Kent, 'Elizabeth I and the Limits of Privatisation' (1998) 58 *Public Administration Review* 99.

## II THE CONCEPT OF ACCOUNTABILITY

Before considering the mechanisms for regulating business and whether they provide adequate tools for public accountability, an understanding of what is meant by the term ‘accountability’ is essential. Accountability, in its commonly understood sense, means ‘the direct relationship of authority by which one party accounts to a body or person for the performance of tasks or functions conferred, or able to be conferred, by that person or body’.<sup>2</sup>

Under the Westminster system of government, executive government is held accountable in two ways. First, it is held accountable by the Parliament (as Cabinet Ministers are members of Parliament and subject to questioning and debate in Parliament) and, ultimately, by the voting public. Appointed public servants are accountable to their Ministers and through them to the Parliament. Second, executive government is held accountable legally by an independent judiciary or other independent quasi-judicial bodies, usually applying constitutional or administrative law to the actions or decisions of the executive.

The private sector is governed by a different set of rules. While there are general legal rules (in the form of common law and statute law, such as, the *Corporations Act 2001* (Cth) (*‘Corporations Act’*) and *Criminal Code Act 1899* (Qld)) and rules of specialised bodies (such as the stock exchange), accountability for the most part is left to the market place. Here, individual pecuniary interests and maximising the return on shareholders’ funds take precedence over concerns such as equity or procedural fairness to citizens.

If private citizens are not subject to the same set of rules as government employees, what do we mean by accountability in an environment which is an amalgam of private sector and public sector expectations?

In a thought provoking book, *Rethinking Democratic Accountability*,<sup>3</sup> Behn suggests that when we talk about holding people accountable, we usually mean accountability for one of three things: accountability for finances; accountability for fairness; or accountability for performance.<sup>4</sup>

Accountability for finance embodies the traditional concept of accountability – how the books are kept and how the money is spent. This implies accounting by an agent to a principal for their use of resources on behalf of the principal. It is the concept of accountability that is central to research in accounting literature and to the promulgation of many accounting and auditing standards.<sup>5</sup>

Accountability for fairness recognises that democratically elected governments need to be fair when dealing with individual citizens – whether that be taxing them or providing services to them. It goes beyond accounting for how money is spent. While the concept of fairness is less precise than that of financial

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2 Pat Barrett, ‘Public Private Partnerships - Are There Gaps in Public Sector Accountability?’ (Paper presented at the Australasian Council of Public Accounts Committees 7<sup>th</sup> Biennial Conference, Melbourne, 3 February 2003) <<http://www.anao.gov.au/WebSite.nsf/Publications/CF07591C2441E5E74A256CC5002309BF>> at 14 October 2006.

3 Robert D Behn, *Rethinking Democratic Accountability* (2001).

4 Later, Behn adds a fourth form of accountability – accountability for personal probity: see *ibid*.

5 Ken Trotman and Michael Gibbins, *Financial Accounting: An Integrated Approach* (2003) ch 13.

accountability, we have established norms for appropriate behaviour towards citizens including concepts such as procedural fairness, natural justice and non-discrimination.

Behn argues that accountability for finances and accountability for fairness 'reflect concerns for how a government does what it does'.<sup>6</sup> However, citizens also care about what government does and what it actually accomplishes. In response, Behn introduces his third concept of accountability: accountability for performance. Public agencies are responsible for more than keeping customers happy; they are responsible to the whole citizenry for what they do.<sup>7</sup>

If public accountability requires information on each of these three aspects is it possible for our normal private sector accountability mechanisms to satisfy these requirements, and if not, what can they do?

### III REGULATING THE CONDUCT OF CORPORATIONS

A PPP most often consists of a private sector entity (such as a limited liability company with one or more private sector corporations as shareholders), which has a formal contractual relationship with government covering the sharing of risks, capital and, perhaps, control. Since most PPP activity involves some form of corporate structure, it is necessary to consider the regulation of companies.

According to Kent, 16<sup>th</sup> century privatisation of naval activity through the use of joint stock companies or partnerships was accompanied by a number of public policy problems.<sup>8</sup> Among these problems were:

- the profit motive impeding the achievement of public policy objectives (for example, privateers, private providers of naval warfare, plundered ships of both friends and foes);
- obstructing needed investment in public sector assets (for example, the underinvestment in the Royal Navy); and
- public officials having a conflict of interest when performing their regulatory role (for example, the Admiralty received 10 per cent of the value of any prize taken which reduced the incentive of Admiralty to closely monitor which nation's ships were plundered).<sup>9</sup>

Thus, the establishment of PPPs with private sector involvement (or the straight privatisation of activities) did not result in a ready public accountability for the activities undertaken.

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6 Behn, above n 3, 9.

7 Koppell suggests Behn gives insufficient attention to the nature of accountability – for example, does accountability for finances mean managing finances in accordance with accepted procedures or managing in an open and reviewable fashion? Koppell develops five dimensions of accountability: transparency, liability, controllability, responsibility and responsiveness: see Jonathan G S Koppell, 'Pathologies of Accountability: ICANN and the Challenge of "Multiple Accountabilities Disorder"' (2005) 65 *Public Administration Review* 94.

8 Kent, above n 1.

9 *Ibid.*

Since the 16<sup>th</sup> century, there have been significant developments in corporations law with consequential improvements in corporate accountability. These developments include specifying the roles and responsibilities of directors, increasing disclosure to external parties, formalising the responsibilities of external auditors and implementing statutory requirements for accounting standards. The question is, have these developments ameliorated the type of 16<sup>th</sup> century problems enunciated above and, thus, permitted the modern corporation to be a better regulatory tool for PPPs?

Today, corporations law clearly identifies the board of directors as the control body of the corporation. Directors owe their primary responsibility to the corporate entity and must operate in good faith in the best interests of the company. Their decisions as directors are evaluated according to the business judgment rule which, in Australia, is set out in section 180 of the *Corporations Act*.

The *Corporations Act* also recognises that directors have a responsibility to keep owners of the corporation informed about its operations so, consequently, sets out in more detail the required disclosure. Items that need to be disclosed include, among other things: information on the directors themselves;<sup>10</sup> the financial performance and prospects for the company;<sup>11</sup> and, on a continuous basis, events which may affect the market value of the corporation.<sup>12</sup>

The emphasis on disclosure and stewardship in financial reporting is reinforced in Australian accounting standards which are adopted by regulation. The independence of auditors and their responsibility to inform shareholders is formalised in the *Corporations Act*. Likewise, disclosure and other requirements are contained in the listing requirements of the market operator for listed securities, the Australian Stock Exchange ('ASX'). Again, the position of a market operator is incorporated in the *Corporations Act*.

The striking feature about the above mechanisms and rules is their concentration on the relevance of behaviour and information associated with the best interests of the corporate entity and those providing (or potentially providing) financial capital to the corporation. In other words, corporate accountability is nearly always defined in terms of the director's role in corporate control and accountability for finances. A public policy perspective with its accountability demands is not in the picture.

The reason for this orientation is probably twofold. First, the predominant legal view is that the primary purpose of a board is as a fiduciary charged with monitoring management for the benefit of the corporation. Second, over the centuries, many of the drivers for developments in corporate law have been the spectacular financial failures, and subsequent loss of shareholder funds, such as those associated with the South Sea bubble (1720), the United Kingdom Railway bubble (1845), the stock market crash (1929), and, more recently, the internet

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10 *Corporations Act 2001* (Cth) s 191.

11 *Corporations Act 2001* (Cth) Pt 6D.2.

12 *Corporations Act 2001* (Cth) s 674.

bubble (2000) and financial frauds occurring in companies like WorldCom, Enron and HIH.

A good example of the difficulty of relying on business mechanisms to ensure public accountability is provided by the Australian Magnesium Corporation ('AMC') and the financial support it received from government. Although not strictly a PPP, it does highlight the information and accountability issues involved.

In October 2001, AMC issued a prospectus to raise \$525 million from the public through what was termed 'Distribution Entitled Securities' or 'DES'. The prospectus detailed the financial loans and related commitments it was to receive from the Queensland and Australian Governments.<sup>13</sup> In fact, AMC received significantly more support from the Governments than disclosed in the prospectus. In the AMC Annual Report 2002, it was disclosed that the Queensland Investment Corporation ('QIC'), a Queensland Government owned corporation, purchased over 28 million DES.<sup>14</sup> In addition, QIC held over 6.5 million AMC shares and over 3.5 million options. The Annual Report also disclosed that the Commonwealth Scientific and Industrial Research Organisation ('CSIRO'), an Australian Government entity, also had significant share (318 000) and option (159 000) holdings in AMC. Each of these holdings was disclosed only because they fell in the top 20 holdings in each category.

AMC was not required to disclose that it had received substantial stamp duty relief from the Queensland Government; this only became public during a July 2002 Parliamentary Estimates Committee hearing, and did so almost as an aside and quite incidental to the thrust of a question asked by the Committee.<sup>15</sup>

There is no question that AMC acted in a way that met the requirements of the *Corporations Act* and relevant accounting standards in their 2001 Prospectus. AMC met the traditional accountability for finances criterion of accountability.

However, for a citizen attempting, in October/November 2001, to evaluate whether the Government commitments were appropriate in a public policy sense, it would have been relevant to know the full extent of government (that is, taxpayer) support that was committed or intended. It is this broader public policy concept of accountability that has been referred to as 'accountability for performance'. The fact that full disclosure of the relevant information was delayed and, then, was only available in quite diffuse sources unlikely to be accessed by most citizens, simply leads to the conclusion that corporate accountability, fully met in this instance, was an inadequate basis for public accountability.<sup>16</sup>

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13 Australian Magnesium Corporation, *Prospectus* (15 October 2001) 31 (copy available at Advanced Magnesium Limited Library Archives, Level 9, 303 Coronation Drive, Milton, Queensland).

14 Australian Magnesium Corporation, *Annual Report 2002* (2002) 82-3 (copy available at Advanced Magnesium Limited Library Archives, Level 9, 303 Coronation Drive, Milton, Queensland).

15 Queensland, *Parliamentary Debates*, Estimates Committee A – State Development, 9 July 2002.

16 A more detailed discussion of these and other accountability issues involved can be found in David J H Watson, 'The Rise and Rise of Public Private Partnerships: Challenges for Public Accountability' (2003) 13(3) *Australian Accounting Review* 2.

A related disclosure question important for evaluating PPPs and relevant to the behaviour of private sector entities is their use of proprietary information and the issue of commercial-in-confidence arrangements with government.

While it is recognised that companies use proprietary or confidential information to obtain commercial returns, not all information used to obtain commercial returns has the necessary characteristics to classify the information as confidential. However, without an explicit legal requirement or a clear competitive advantage, there is no incentive for the private sector to voluntarily incur the cost of disclosing information and, potentially, some advantage to them of reaching agreements with government to restrict the flow of information to outside parties.

Consequently, it is not surprising that parliamentary inquiries routinely find that commercial-in-confidence arrangements between the private sector and executive government severely restrict the public flow of information.<sup>17</sup> The recently completed inquiry by the New South Wales Public Accounts Committee ('PAC') into PPPs confirmed this trend when the Committee concluded that it was difficult to obtain specific information on projects and that this reduces the capacity to determine a project's value to the community.<sup>18</sup>

The *Corporations Act* regulates the behaviour of private sector entities operating in competitive markets. As such it establishes a limited set of disclosure rules aimed at permitting informed judgments about the financial performance of a company. The private sector, as Rosenau has stated, is weak on transparency, but this is required if public scrutiny, a taxpayer's right, is to be assured.<sup>19</sup> Consequently, if information on contracts with government is to be made public, explicit guidelines, beyond those which are used to regulate transactions between private parties, need to be enacted. The 2002 Queensland PAC Report suggested such a set of guidelines<sup>20</sup> and the recent New South Wales PAC Report recommended similar guidelines for PPPs.<sup>21</sup>

However, it is not all doom and gloom. There are some aspects of PPPs which mean that the private sector can enhance public accountability.

First, it is now common for government services to be split between 'core' and 'non-core' services. Core services are those where there is a direct interface between the public sector and citizens and where the government has a high level duty of care (for example, clinical services in public hospitals would be classified as core services whereas laundry services would be classified as non-core). If PPPs are restricted to providing non-core services, accountability for finances is

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17 See Public Accounts and Estimates Committee, Parliament of Victoria, *Inquiry into Commercial in Confidence Material and the Public Interest* (2000); Public Accounts Committee, Parliament of Queensland, *Commercial-in-Confidence Arrangements* (2002).

18 Public Accounts Committee, Parliament of New South Wales, *Inquiry into Public Private Partnerships* (2006). A notable exception to this trend is the PPP recently established by the Brisbane City Council which has placed on its website virtually all the documentation associated with its North-South Bypass Tunnel Project: see River City Motorway <<http://202.148.140.135/home/default.asp>> at 11 October 2006.

19 Pauline V Rosenau, 'Introduction: The Strengths and Weaknesses of Public Private Partnerships' (1999) 43 *American Behavioral Scientist* 10.

20 Public Accounts Committee, Parliament of Queensland, above n 17.

21 *Ibid.*

more likely to satisfy public accountability concerns and, thus, normal commercial incentives may be sufficient as a regulatory tool.

Second, PPPs normally require a detailed specification of the services to be provided by the entity and the standards to which these are to be performed. Provided these standards are benchmarked and the key performance measures regularly made public, this process potentially provides a basis for greater accountability compared to traditional government service delivery.

To some extent these two mechanisms help overcome 'the profit motive impeding the achievement of public policy objectives' referred to earlier. They do so by essentially removing many of the potential public policy concerns from the PPP project and then attempting to reduce the uncertainty in performance expectations which is inherent in long-term contracts.

Third, there is some empirical evidence that PPPs do provide a better delivery method for public infrastructure than traditional methods. United Kingdom Treasury research, published in July 2003, indicated that PPPs met initial expectations and delivered most projects on time, within public sector budgets. These projects also compared favourably with previous non-PPP projects.<sup>22</sup> This would imply that PPPs are meeting broader social objectives effectively. While this may be the case in general, evaluating the performance of specific PPP projects is more complex.<sup>23</sup>

Finally, listed companies do have limited disclosure requirements with respect to their public or social responsibilities. Under ASX Listing Rules (rule 4.10), public companies are required to follow good corporate governance guidelines published by the ASX.<sup>24</sup> One guideline (principle 10) recommends companies recognise and address their social responsibility in the way the business is conducted.<sup>25</sup> While this guideline is not sufficiently broad to act as a regulatory mechanism for most PPPs, it does provide some public accountability content in areas such as the environment, equal opportunity employment, adherence to fair trading laws, trade practices and like business activities.

#### IV CONCLUSION

While each of the issues discussed in the paragraphs immediately above help moderate the public policy issues involved with the use of PPPs, the fundamental question of whether the introduction of the private sector enhances or impedes accountability of the public sector remains.

Public accountability requires governments to be answerable to its citizens not only for the efficient use of taxpayer resources, but answerable also for the way

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22 See Her Majesty's Treasury, *PFI: Meeting the Investment Challenge* (2003) <[www.hm-treasury.gov.uk/documents/enterprise\\_and\\_productivity/PFI.cfm](http://www.hm-treasury.gov.uk/documents/enterprise_and_productivity/PFI.cfm)> at 11 October 2006.

23 For a discussion of the range of issues involved, see David J H Watson, 'The Challenge for Public Accounts Committees in Evaluating Public Private Partnerships' (2004) 14(2) *Australian Accounting Review* 78.

24 ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003) Australian Stock Exchange <<http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf>> at 12 October 2006.

25 *Ibid* 59–61.

citizens are treated when those resources are used and the purposes for which the resources are used. Unlike the private sector, which acquires resources through voluntary action on the part of citizens, governments acquire resources from citizens through compulsory action. This considerably raises the accountability threshold.

Consequently, it is perhaps unwise to expect that organisations designed for effectiveness in a voluntary competitive market and accountability mechanisms designed for corporate accountability are sufficiently flexible to regulate the behaviour of governments and to fulfil the wider accountability expectations held of governments.

The point is succinctly made by Gilmore and Jensen:

Because private actors are not subject to the same constitutional, statutory and oversight restrictions as governmental actors, delegation of public functions outside the bounds of government profoundly challenges traditional notions of accountability, making it all the more difficult, as James Madison put it, to ‘oblige government to control itself’.<sup>26</sup>

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26 Robert S Gilmore and Laura S Jensen, ‘Reinventing Government Accountability: Public Function, Privatisation and the Meaning of “State Action”’ (1998) 58 *Public Administration Review* 247.