

CREATING A FRAMEWORK FOR PUBLIC-PRIVATE PARTNERSHIP (PPP) PROGRAMS

*A Practical Guide for
Decision-makers*

Jeffrey Delmon



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Twenty years from now you will be more disappointed by the things that you didn't do than by the ones you did do, so throw off the bowlines, sail away from safe harbor, catch the trade winds in your sails. Explore, Dream, Discover.

—Mark Twain

Public private partnerships (PPP) represent an approach to procuring infrastructure services that is radically different from traditional public procurement. It moves beyond the client-supplier relationship when Government hires private companies to supply assets or a service. PPP is a partnership between public and private to achieve a solution, to deliver an infrastructure service over the long term. It combines the strength of the public sector's mandate to deliver services and its role as regulator and coordinator of public functions with the private sector's focus on profitability and therefore commercial efficiency.

"PPP" is used here in its most inclusive form, to mean any contractual or legal relationship between public and private entities aimed at improving and/or expanding infrastructure services. Clearly, the more extensive the private involvement, the more supportive the investment climate needs to be. The term "Government" will be used to mean the level of Government responsible for the reform processes, whether it be the federal, state or municipal Government. The two counterparties to the main project contract will be referred to as the "contracting agency" on the public side and the "project company" on the private side. PPP can be implemented as a series of ad hoc projects or as a program of projects coordinated and enabled centrally. This text discusses the latter—"PPP programs".

One of the challenges for Governments wanting to implement a conducive PPP framework is the variety of models and approaches put forward by different countries, advisers and commentators. A common approach is to try to adopt the fully functioning framework used by a country that has been very successful in developing a PPP program, in one fell swoop. This involves taking, for example, the PPP program in England and Wales and replicating it wholesale

for any given country. But, these “best practice” PPP programs have developed over many years, through numerous challenges and frustrations and for a specific legal, political and financial context. When adopting the processes and procedures of one of these countries wholesale into a jurisdiction with little experience in PPP, the tendency is to expect the PPP program to be equally successful in a short timeframe, as if a robust PPP framework will immediately result in robust PPP projects. Clearly, this is not accurate.

This text suggests that development of a conducive framework for PPP involves a dynamic, iterative process supported by different functions and actors within the Government, the private sector and the communities in question. Transparent, competitive selection of the private partner is fundamental to provide a level playing field, foreseeable processes and best price, terms and conditions for the Government. Instead of proposing a single model, this text discusses the different elements that together make up an effective PPP framework.

Figure 1.1 identifies what it takes to achieve a good, sustainable PPP framework:

- the political will to pursue PPP, and the legal and regulatory regime appropriate to enable and encourage PPP
- selection, design and development of “good” projects—the most appropriate and feasible projects for PPP
- allocating risk to the private sector while insulating investors from those risks best borne by the contracting agency or the Government
- ensuring that the financial markets are in a position (legally, financially and practically) to provide the project with the investment it needs (debt, equity and otherwise), including by providing Government support.

Generally, simpler is better. As a PPP program matures, the PPP framework may become more complex. But in the early days, it is generally better to keep the framework simple. Different constituencies will need to understand the framework – contracting agencies, line ministries, central ministries, investors, and the public at large. Simple mechanisms will help these key stakeholders understand and interact with the PPP framework more easily.

Figure 1.1: The Context of a Conducive PPP Framework

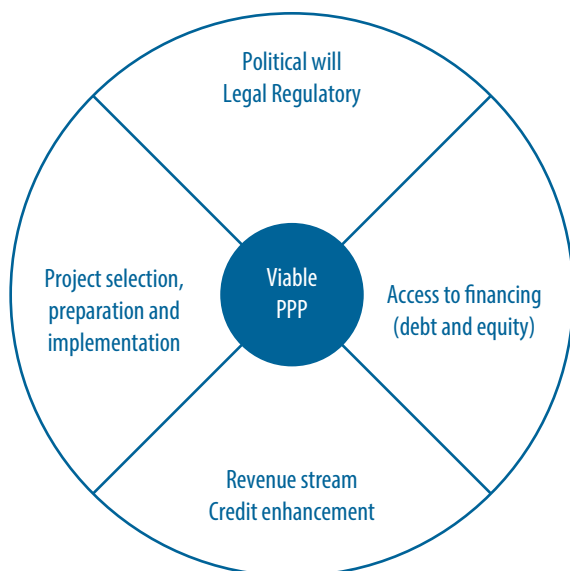


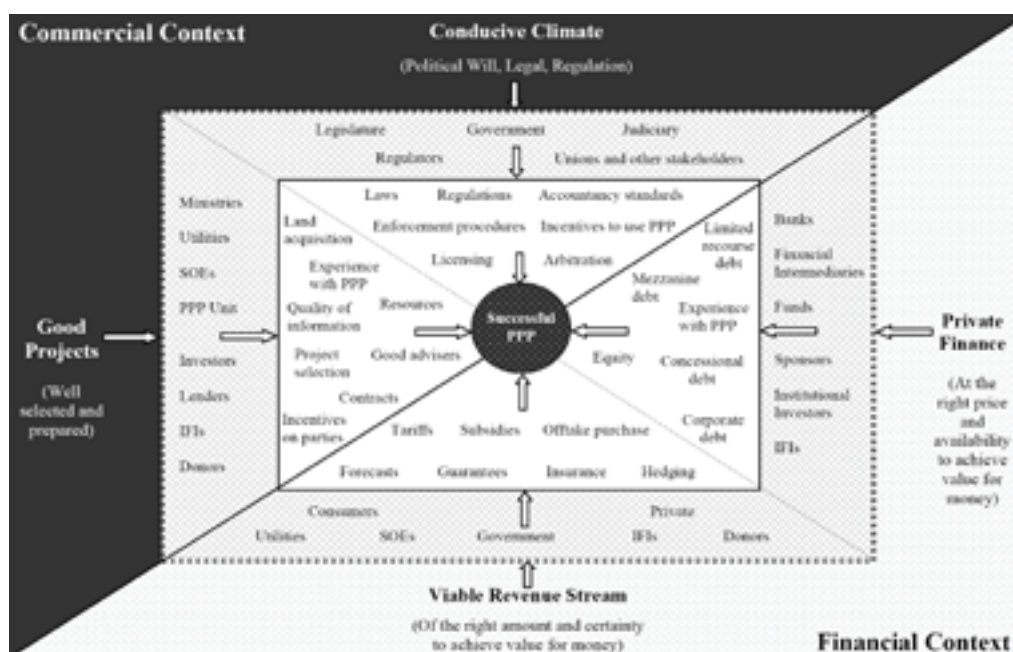
Figure 1.2 shows a more detailed depiction of the diversity of reforms and instruments that together can support a good, sustainable PPP program. The outer square shows the macro issues. The middle square identifies the key participants in achieving each of the macro-drivers.

The inner square shows the tools available to those participants. One worth highlighting is “experience with PPP”. It is important for the contracting agency, investors and lenders to have access to individuals experienced with PPPs, to help them understand the risk profile, terms and conditions, market standards and financing arrangements typical of such projects.

A gap analysis identifies areas in the PPP framework that can be improved.

The main activities to be addressed in this strategic plan for PPP framework reform will include:

Figure 1.2: PPP Investment Climate



- establish policy
- draft and pass necessary laws and regulations
- create, staff and coordinate institutions, committees and task forces
- create operating guidelines and best practice guidance to establish transparent, competitive processes
- select and develop a pipeline of good projects, including strategic demonstration projects
- establish processes, practices and funding for Government support, including project preparation and fiscal risk management
- implement program monitoring, knowledge capture, and sharing of lessons learned.

An action plan for PPP framework reform will focus on practical actions associated with these topics. There is a tendency to approach reform of the PPP framework as a single action, generally delivered by external consultants in one massive report, with a few workshops and training sessions (in an effort to deliver the guidance in a more digestible form). But such interventions are rarely effective.

On the contrary, achieving a viable PPP framework involves a complex series of parallel, iterative initiatives and efforts. It involves updating the different elements of the PPP framework discussed in this text as each new lesson is learned from PPP transactions as they are implemented and national best practice as it develops.

Section 1 introduces the framework required to support PPP and provides a summary of the text. Sections 2–6 then describe five key elements of the PPP framework and what the Government can do to improve them:

- The legal framework—how laws and regulatory structures can be used to encourage PPP, support the institutions implementing PPP and regulate them (section 2)
- The institutional framework—the people involved, the decision making power they have and the functions they perform (section 3)
- The project procurement process and Government involvement in each phase thereof (section 4)

Key Messages for Policy Makers

- *Learning by doing*—an important part of identifying gaps in the investment climate is learned while “doing”, while implementing PPP projects.
- *Use small steps without being timid*—start with easier projects that are clearly financially viable and have political support. But these projects need to provide a signalling effect; they need to be sufficiently substantial and strategic to ensure Government buy-in, the interests of private investors and a statement to the market that the framework for PPP in the country is conducive.
- *Learn from the experiences of others, without being dogmatic*—there is a tendency to try to replicate the successes of other countries. While it is important to learn from the successes and failures of others, it is generally unwise to try to replicate an entire framework, wholesale.
- *Keep it simple*—complex is not necessarily comprehensive or better, the PPP framework needs to be understood by a wide group of stakeholders.

- Using Government funding to support project viability, maximize competition, reduce financial risk and keep project costs low (section 5)
- Mobilizing long-term local currency financing for PPP projects, for example by using a financial intermediary (section 6).

This text is adapted from Jeffrey Delmon, *Public-Private Partnership Programs: A framework for private sector investment in infrastructure* (Kluwer

International 2014).¹ Key messages for policy makers are provided throughout the text, with a full list of these set out in an annex.

¹ For further discussion of the development and financing of PPP, see Delmon, *Public Private Partnership Projects in Infrastructure: An essential guide for policy makers* (Cambridge University Press 2011); and Delmon, *Private Sector Investment in Infrastructure: Project finance, PPP projects and risk* (Kluwer International 2ed, 2009).

“It is more fun to talk with someone who doesn’t use long, difficult words but rather short, easy words like “What about lunch?”

—Winnie-the-Pooh (A.A. Milne)

The Government will wish to create a clear and stable legal environment for PPP projects, in order to reduce the perception of risk, attract more competition for projects, attract more lending and therefore reduce project costs. The legal (and regulatory) framework creates the foundation for the institutional, regulatory, commercial and financial environment for PPP with clarity, consistency, transparency and certainty. It is particularly critical for the institutional framework, describing the interactions, relationships and coordination that underpin that framework. For this reason, this text describes the legal framework first. However, the reader will need to read this section in close conjunction with sections 3–6 to understand how the legal framework will create and support the institutional and financial dynamic of the PPP framework.²

2.1 SETTING AND IMPLEMENTING THE PPP LEGAL POLICY

Successful PPP frameworks have clear, well-understood and documented policies. The PPP policy must provide clarity to stakeholders (public and private) on how the Government wants to undertake PPPs. The policy should include:

² For further discussion of these issues, and their application in different jurisdictions, see Delmon and Rigby Delmon, eds., *The Law of Project Finance and PPP Projects in Frontier Jurisdictions* (Kluwer International 2013). In relation to legal frameworks, the reader may also wish to consult the PPP in Infrastructure Resource Center website, which describes PPP in infrastructure legal frameworks, sample laws, regulations and contracts. www.worldbank.org/PPP; UNCITRAL, *Legislative Guide on Privately Financed Infrastructure Projects* (UNCITRAL 2000); UNCITRAL, *Model Legislative Provisions on Privately Financed Infrastructure Projects* (UNCITRAL 2003); UNIDO BOT Guidelines (UNIDO, 1996); European Commission Guidelines for Successful Public-Private partnerships (2003); OECD Basic Elements of a Law on Concession Agreements, (1999–2000); Concession Assessment Project, (European Bank for Reconstruction and Development 2004).

- Purpose of the PPP policy: vision, mission and goals
- Definition of PPP, for example, projects will be considered PPP if:
 - the private partner provides some combination of the design, construction, funding, management, maintenance and operation of infrastructure
 - the project provides long-term, performance based services.
- Identification of responsibilities amongst Government entities, including
 - selecting projects for PPP, project promotion, development and marketing
 - Government support allocation and managing fiscal risk
 - regulation of performance and monitoring implementation
 - gathering of know-how and lessons learned, standardization, operating guidelines.
- Government approval must be sought, at different stages of the project.
- Conditions to the allocation of Government support or liabilities.

PPP legal frameworks are often anchored in a legal instrument that implements the PPP policy.³ These may be called PPP laws, concession laws, BOT laws or otherwise. Or the legal framework may be embedded in other legal instruments (laws, decrees or regulations), for example related to procurement,

infrastructure sector regulations, Government finance or privatization.

The need for a specific law or set of regulations associated with PPP will depend on the nature of the legal system and current legal framework. In some legal systems, in particular those applying Civil Law, PPP laws and the like are common, as a way to formally sanction PPP and specify the extent to which it is a permissible method of procurement for Government entities, for example, Russia and Thailand have passed specific PPP laws.

In some cases a law would be too political, or would simply take too long, and therefore PPP regimes are established in PPP regulations, as secondary legislation. This was the approach taken in Nigeria, with PPP regulations created under the public procurement law (though a PPP law was before Parliament in Nigeria, at the time of writing this text). In Indonesia, the PPP “law” was implemented through a Presidential decree (a “Perpres”), which in the legal hierarchy is inferior to laws and Government regulations. This has created difficulties where sector procurement processes implemented under Government regulations are inconsistent with the PPP decree; the Government is considering a PPP law.

In other systems, in particular Common Law systems, PPP laws are less common. The UK does not have a separate PPP law. The PPP function was created within the Treasury, thus the PPP processes were enforceable not by law, but by the intervention of a powerful central ministry which created incentives to ensure compliance.

Whatever the legal authority supporting PPP, detailed operating guidelines are needed to ensure consistency of practice amongst those implementing PPP, transparency for Government entities and investors as to applicable rules and efficiency through common practices. For example, in the Philippines, the amended Build Operate Transfer

Key Messages for Policy Makers

- *PPP policies should be clear, comprehensive, yet flexible*—periodic updates are a useful way to adopt lessons *learned into the PPP program.*
- *Keep the legal framework simple and clear.* Do not confuse complexity with comprehensiveness. Simple is better, and will give more confidence to investors. Detail is best left to secondary legislation that is more easily amended to respond to change.
- *Do not use the legal framework to second guess the PPP contract by creating rights and obligations at law that should be addressed in the contract on agreed terms.* If the Government is keen to establish such terms, standard form documents can achieve this, where the terms can be spelled out in detail.

³ Examples of PPP legal instruments can be found at www.worldbank.org/pppiresource.

(BOT) Law is supplemented by detailed and clearly written implementing rules and regulations, the investment and coordination committee guidelines and procedures, and a series of forms and checklists that must be utilized by the implementing agencies and local Government units during project selection and development, which are periodically reviewed and revised based on lessons learned. In Colombia, Conpes issues written policy decisions, improving the PPP legal framework as it gains experience with PPP project implementation.

2.2 KEY LEGAL CONSTRAINTS

This section provides a brief introduction to the most critical legal issues for a PPP framework.⁴ It describes issues and sets out the kind of questions that an investor will ask when doing due diligence on a country's legal system.

2.2.1 Vires

The PPP legal framework will need to describe which Government authorities and entities have the power to perform different functions associated with a PPP project. An ultra vires act is one performed outside of a party's legal rights, for example where a party enters into an obligation or agreement which it is not empowered to undertake. An ultra vires obligation or agreement may be void by law. This doctrine can affect the acts of private companies and Government bodies.

2.2.2 Government obligations and support

PPP projects are often not viable without some form of Government support, e.g. the provision of land, assets, subsidies, guarantees or other value, in particular when the central Government is not a party to the key project agreements, or the infrastructure service does not in and of itself generate sufficient revenues.⁵

Investors will need to know the forms Government support can take processes and criteria for approval of Government support, and whether Government support is binding on the Government, or is

it voidable, e.g. where budget allocations are insufficient.

2.2.3 Creation of limited liability project company

Project financing relies on the limited liability nature of project vehicles to achieve limited recourse financing, and subject to the ability of courts to look through the limited liability nature of the entity, for example through piercing the corporate veil.⁶

2.2.4 Procurement

Procurement requirements are generally aimed at maximizing the efficiency of the process, reducing opportunities for corruption and encouraging open competition.⁷ The selection process should be specified, creating a fair and transparent set of tender rules, with limited exceptions allowing direct negotiations, mechanisms for implementing unsolicited proposals (or rejecting them entirely—see section 4), and the applicable regime for challenging project awards.

2.2.5 Land rights and acquisition

PPP projects, particularly in the transport sector, can be land intensive. Therefore, the ability of the Government to use compulsory acquisition (expropriation) of land without undue delay is essential. This acquisition generally involves judicial and administrative proceedings to set the land aside (to avoid squatters inhabiting the land once the project becomes known, or speculators depriving land owners of their entitlements), allow the Government to seize the land, and establish the amount of compensation to be paid to the owner of the land and any other affected party. Ideally, this regime will

⁴ A more complete discussion of the legal issues that are important to PPP projects can be found in Delmon and Rigby Delmon eds., *International Project Finance and PPPs: A legal guide to key growth markets* (2013).

⁵ See section 5 for further discussion of Government support.

⁶ See Delmon, *Private Sector Investment in infrastructure: Project finance, PPP projects and risk 2ed* (Kluwer International 2009) for further discussion of limited recourse structures.

⁷ For further discussion of public procurement requirements, see section 4 and 5 of Scriven, Pritchard and Delmon (eds), *A Contractual Guide to Major Construction Projects* (1999).

allow the Government to acquire the land quickly while providing clear rights to compensation and resettlement, to provide certainty to all stakeholders.

2.2.6 Setting and collecting tariffs

To the extent the project company must rely on tariffs from consumers as the basis for its revenue stream, the legal framework will need to define:

- How those tariffs are set, whether they can be set by contract, on what basis they are adjusted over time
- Any limitations to the basis on which tariffs can be set, for example can they be set based on profit margin/rate of return, foreign exchange rates or cost of debt?
- Is the project company entitled to collect tariffs from consumers? Can the project company enforce its right to collect tariffs through penalties or disconnection/denial of access?

2.2.7 Penalties, sanctions and bonuses

The project, in order to align incentives, will include a regime of sanctions or penalties for failure by project parties to comply with their contractual obligations, for example on the project company for sub-standard service delivery and on the construction contractor for late completion.

Jurisdictions treat penalties or liquidated damages differently. Some jurisdictions allow them so long as they are reasonable, others require them to be a genuine pre-estimates of the damage likely to be suffered, for example in England. Still others allow the court to modify such penalties in order to achieve reasonableness, in particular where one of the counterparties is a public entity, for example in France. There may be limitations on charging interest on interest or on imposing a rate of interest on judgments that is different than that prescribed by the court.

2.2.8 Security rights over assets

The lender will seek remedies or opportunities to control the management of borrower assets in

the event of its bankruptcy or insolvency.⁸ Each jurisdiction will place different rules on the taking of security over different project rights or assets (existing or future), for example real or movable assets, contractual rights (including future rights as they crystallize), endorsement of insurance policies to the benefit of third parties, rights over bank accounts (ideally fixed and floating charges), and the pledge of shares.

2.2.9 Dispute resolution

Large infrastructure projects are ripe for complex and often debilitating disputes, and often involve parties from a variety of legal, social and cultural backgrounds. Failure to address such disputes early can have devastating impact on a PPP project, and therefore sophisticated dispute resolution mechanisms are generally adopted.

Parties to a PPP project generally prefer to submit any disputes that may arise to arbitration, because of its flexibility and greater ease of award execution,⁹ rather than to state courts. International arbitration benefits from sophisticated arbitrators, speed of process and international conventions on enforcement of international arbitration awards, such as the New York Convention,¹⁰ which require enforcement of international arbitration awards as if they were domestic awards, and do not allow the enforcing court to open up the award and make a qualitative assessment of its merits, except for a few specified reasons.

2.2.10 Sovereign immunity

States generally benefit from two forms of immunity: jurisdiction and execution. State entities are immune from the jurisdiction of the courts of another state. This immunity results from the belief that it would be inappropriate for one state's courts to call another state under its jurisdiction, since this would erode

⁸ See the Annex for further discussion of security rights.

⁹ Execution of arbitral awards is supported by a number of international treaties and conventions, in particular The United Nations Convention on the Enforcement of Arbitral Awards (1958) (the "New York Convention").

¹⁰ United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).

the principle of independent national sovereignty. However, this immunity can generally be waived by the state entity. The state will also have immunity from execution, since it would be improper for the courts of one state to seize the property of another state. Just as courts do not have jurisdiction over foreign sovereign states under international law, they are also prevented from seizing the property of such sovereign states.¹¹ Immunity from execution generally may also be waived.¹²

2.2.11 Employment

Some of the most important reasons for granting the project company the right to operate a public sector service are to improve efficiency, to streamline the relevant corporate and management structures and to transfer commercial know-how from the private sector. However, this improved efficiency may be inconsistent with the interests of existing public sector employees. Applicable law may create restrictions governing the project company's relationship with its employees, whether:

- it is possible to transfer or second public employees to another entity/ contracting party,
- public sector employees that have been transferred to the project company retain their rights and benefits, and will new employees enjoy the same rights and benefits as the transferred employees
- employers can remove dishonest or bad workers, is it possible to impose disciplinary procedures, and the project company can release employees/ make them redundant, and if so, what sort of compensation is required by law/ if any

2.2.12 Tax

PPP projects raise a number of issues associated with taxation of assets, revenues, interest payments and profits. Limited recourse financing creates particular challenges for tax liabilities, e.g. transfer pricing, depreciation, VAT offsetting, and taxation of subsidies. In jurisdictions where limited recourse financing is not common, the application of those tax liabilities may not be fully understood.

Box 2.1: UK Reforms to Improve Transparency

In order to improve transparency the UK Government plans to:

- monitor and disclose all commitments arising from off-balance sheet PPP contracts;
- require the private sector to provide equity return information for publication;
- publish an annual report detailing project and financial information on all projects where Government holds a public sector equity stake;
- introduce a business case approval tracker on the Treasury website; and
- improve the information provisions within the standard contractual guidance.

Source: Infrastructure UK, "A new approach to public private partnerships" (December 2012).

2.2.13 Regulatory frameworks

The Government may be assisted in its monitoring/ management function by third parties. For example, an independent specialist may be appointed under the contract to act as the monitor of compliance with contract obligations by the parties.¹³ Equally, the sector regulator (e.g. the water sector regulator) will be monitoring the project company's performance, and may agree to monitor generally the parties' compliance with their obligations under law, which may well coincide with their obligations under the relevant contracts. The difficulty with this approach is the need for the regulator to operate in accordance with its mandate, with the usual discretion given to regulators. Often, this discretion cannot be limited (or "fettered") and therefore the regulator must comply with its legal mandate first and its contractual role as a secondary function.

Where the site country has a history of regulation, the regulatory structure may be predictable and

¹¹ O'Connell, *International Law* (2nd ed., 1970) at p 864.

¹² Maryan Maryan, "Negotiating with the Monarch; Special Problems when the Sovereign is your Partner" *Project Financing in Emerging Markets 1996; Successful Development of Power, Mining, Oil and Gas, Telecommunications and Transportation Projects* at 122 (1996).

¹³ Tremolet, Shukla and Venton, *Contracting Out Utility Regulatory Functions* (World Bank 2004).

may provide comfort to the project company and especially to the lenders. However, in many cases the regulator's role may be new, possibly the product of a hasty response to the involvement of the private sector, or it may not yet exist.

2.2.14 Trusts, agency and other legal relationships

Project financed transactions are highly structured, often with multiple lenders and investors needing to share in the protections provided by such structuring. For these reasons, trust and agency arrangements are often used, where available, to help manage common rights and flow of funds.

2.2.15 Currency

The recurring balance of payment difficulties of many host countries and their need to conserve foreign exchange to pay for essential goods and services greatly reduce their ability and willingness to grant investors the unrestricted right to make monetary transfers, hence many countries have exchange-control laws to regulate the conversion and transfer of currency abroad. The host country may limit the extent to which local currency can be converted into foreign currency, the rate that can be obtained in such a transaction, how much of such currency can be transferred off-shore, which will be essential to pay foreign lenders and to repatriate profits off-shore.

The rain came down, the streams rose, and the winds blew and beat against that house; yet it did not fall, because it had its foundation on the rock. But everyone who hears these words of mine and does not put them into practice is like a foolish man who built his house on sand. The rain came down, the streams rose, and the winds blew and beat against that house, and it fell with a great crash.

—Jesus, Matthew 7:25–27

The creation of a PPP program requires a well-designed institutional framework, with clear and strong political support. A robust institutional framework organizes, coordinates and focuses the resources of the Government in the manner best suited to encourage and enable PPP. This section will review the institutional framework needed to promote PPP by describing the responsibilities to be allocated to different Government entities, the project development process, the different approvals required at key decision points during the project, and how the Government supports PPP transaction preparation, procurement and implementation.

Key Messages for Policy Makers

- *Make sure the different roles are allocated and that the system works, ideological purity is less important.*
- *Institutions are only as good as the people in them, and the funding/mandate they are given. Real capacity building (not just the occasional training or trip abroad) is key to a sustainable programme.*
- *Strong, consistent leadership is key—coordination amongst different institutions and ensuring consistency of practices and focus of efforts generally requires clear direction from the highest levels of Government.*
- *A robust value for money assessment and transparent, competitive procurement can protect the Government and the project from ex-post criticism, and can make the project less vulnerable to change, external shocks and the temptation of future Governments to reverse decisions.*

Creating a PPP program requires the mobilization of significant expertise and effort from dedicated teams, with the resources and political clout to perform their functions. Strong “PPP institutions” can help, as discussed above.

A quick comparison of the PPP programs in India, South Africa, Korea, the Philippines and the UK¹⁴ shows a few common themes emerging:

- India, South Africa, Korea and the UK have multi-stage approvals for their PPP projects and all relate to the commitment of public funds or contingent support; all four countries have the MoF leading on approvals based on economic viability (as a project) plus value for money and risk assessment as a PPP
- India, South Africa, Korea, the Philippines and the UK have public finance support mechanisms, such as capital grants to PPPs
- None of the countries’ PPP Units are able to effectively select PPP projects and all are dependent on contracting agencies for project identification
- None of them take the risk and responsibility of acting as the procuring authority
- All are publically owned and funded.

The Egyptian PPP Unit provides an interesting contrast, based in the ministry of finance, publicly owned and funded and without the power to select projects, like the others. But unlike most national

PPP units, the Egyptian PPP unit takes on the role of procuring entity, driving the process, much like some of the subnational PPP units e.g. British Columbia, Canada or Saint Petersburg, Russia.

3.1 COORDINATION OF PPP PROGRAM

PPP involves a significant shift in mind set, processes and practices in Government development, management and procurement of infrastructure. This shift requires a strong effort from Government policy-makers and staff to drive PPP policy implementation and coordinate Government efforts. The coordination function helps to streamline Government PPP activities, and ensure consistency of Government support for PPP.

A separate entity or steering committee may be created to ensure coordination amongst the different Government agencies (usually a high-level group, possibly cabinet level) with a technical committee supporting it (in particular at a project level). Coordinating the different Government ministries and agencies that will provide critical inputs into any successful PPP program or project can be a particular challenge.

¹⁴ Dachs, International Benchmark Comparator Report February 2013.

Box 3.1: PPP Units

Many jurisdictions use a centralized institution to provide capacity (often known as a “Public-Private Partnership (PPP) Unit”), generally located within or attached to a key ministry that provides resources for project development or other incentives to use PPP. Typically PPP units have a number of functions, including:

- improving the policy/legal/regulatory context for PPP
- ensuring that the PPP programme is integrated with overall planning, fiscal risk management and regulatory systems
- ensuring that projects protect government environmental and social interests and comply with relevant requirements
- promoting PPP opportunities at national and regional levels, amongst potential investors and the financial markets and developing those projects that maximize value for money, competition and sustainability.

The PPP unit can provide a single point of contact for investors and government agencies alike, coordinating PPP activities across sectors so that the PPP program is as uniform and consistent for investors as possible. A PPP unit usually works best when connected with a key ministry or department (such as the ministry of finance or planning). PPP units with executive powers tend to work better than those who provide solely advisory services as they have more influence over contracting agencies.

In most countries with successful PPP programs, the program and initial projects were strongly and personally backed by the president or prime minister. For example, in both Colombia and the Philippines, the president chairs the inter-ministerial committee responsible for PPP projects. In the Netherlands, Australia and the United Kingdom, decisions on major PPP projects, as well as the overall PPP program, are made by the cabinet, which is chaired by the prime minister. In India, the Cabinet Committee on Infrastructure (CCI) decides on infrastructure sector projects and monitors their performance. This 12-member committee is headed by the Indian prime minister.

In Kenya, a PPP Steering Committee has been created at permanent secretary level with representatives from key central ministries and line ministries as well as the attorney general.¹⁵ The steering committee is a high level body that reviews project issues periodically and solves critical problems as they arise, e.g. where a Government agency is not providing inputs in a timely manner, where a constraint will require additional support from a Government agency, or where an agency's activities are constraining the project.

The most common approach is to create a single PPP unit to promote PPP, assess potential projects and help manage Government liabilities. For example, South Africa created a PPP unit in the Ministry of Finance, as did the United Kingdom, with the Treasury Taskforce, which became Partnerships UK and recently split into Infrastructure UK and Local Partnerships.¹⁶

However, there is an inherent conflict of interest where the same entity is responsible for promoting PPP and monitoring/regulating the risks borne by the Government. The promotions team is incentivized to bring projects to market, which may conflict with the need to reject projects that do not represent value for money for the Government.

The importance of legal, environmental and social concerns, including issues as diverse as labour unions and foreign investment criteria (often established by treaty or compacts like the equator

Box 3.2: South Korea's PPP Unit

The Republic of Korea introduced the Promotion of Private Capital into Social Overhead Capital Investment Act (PPP Act) in August 1994. The Ministry of Strategy and Finance is responsible for developing and implementing PPP policies, and chairs the high-level PPP Review Committee that must give final approval to PPP projects. The Public and Private Infrastructure Investment Management Center (PIMAC) at the Korea Development Institute (KDI) serves as a secretariat for the PPP Review Committee. PIMAC has four major functions: i) policy research and strategy; ii) technical support to review proposed PPPs using feasibility studies and value-for-money tests; iii) promote PPP to foreign investors; and iv) education programs on PPP for line ministries/local governments and private partners. Approximately 80 people staff PIMAC, of whom 42 work in the PPP Division. PIMAC is fully funded by the Ministry of Strategy and Finance, with additional resources from fees levied upon line ministries/ local governments for services provided.

Source: Dachs, International Benchmark Comparator Report February 2013.

Box 3.3: South Africa's PPP Unit

A Strategic Framework for PPPs was endorsed by the South African Cabinet in December 1999, and in April 2000, Treasury Regulations for PPPs were first issued in terms of the Public Finance Management Act (Act 1 of 1999). By mid-2000, with technical assistance funding from USAID, GTZ and DFID, the PPP unit was established as a unit within the Budget Office in the National Treasury

The PPP unit also administers a project development facility (PDF) as a so-called "trading entity"—a government financing facility that funds project development as well as recovers funds from successfully closed PPP projects. The PDF cannot appoint the transaction advisors itself, these will either be appointed by the contracting agency or by an intermediary such as the Development Bank of Southern Africa (DBSA) on behalf of the contracting agency.

Source: Dachs, International Benchmark Comparator Report February 2013.

principles), should not be underestimated. These issues form a key part of the public consultation, awareness and relations efforts that will be critical to the success of any PPP program. The PPP agency can help sensitize Government entities to these requirements, ensure consultations are carried out, and help manage back-lash from different constituencies.

¹⁵ www.treasury.go.ke

¹⁶ <http://www.localpartnerships.org.uk/>

Box 3.4: Lessons from London Underground—The Importance of the Regulator

“We consider that the gathering and publication of information by the PPP Arbiter will generally tend to benefit all interested parties: London Underground as client, the Infracos as suppliers and the public as users. The Government should also find such information useful for assessing the benefits and costs of similar proposals in the future. There is some evidence to indicate that an earlier review could have mitigated the impact of Metronet’s collapse, if not averted it entirely. However, it is important that any reporting process is seen as neutral and is designed to provide the information that both the Infracos and London Underground require to address performance issues and to prepare for Periodic Review. It would have been wiser to make the annual review an automatic process rather than one which had to be initiated by a party to the contract.”

Source: House of Commons, Transport Committee, “The London Underground and the Public–Private Partnership Agreements,” Second Report of Session 2007–08, HC 45 (January 2008).

In addition, PPP desks or nodes are often created in different sector ministries, SOEs and local Governments to capture skills and funding at the project implementation level, with close links to the central PPP institutions to ensure cross-fertilization, development of best practice and greater economies of scale for advisers, capacity building programs and other knowledge functions.

Many countries with strong PPP programs make mistakes in connection with their early PPP projects and use the lessons from these experiences to improve their subsequent efforts. South Korea revisits its PPP policy annually to adjust for lessons learned. In Colombia, Conpes has issued more than 100 written policy decisions building on and improving the PPP legal framework as it gains experience implementing PPP projects across multiple infrastructure sectors and with evolving approaches to financing. The Philippine PPP framework is supplemented by a series of detailed and clearly written rules, regulations, procedures, forms and checklists that must be utilized by the implementing agencies

and local Government units during the project selection and development process.

3.2 FISCAL SUPPORT

To encourage line ministries and state owned enterprises to procure infrastructure services through PPP, support may be provided to fund project development costs such as the hiring of suitable expert transaction advisors or the provision of budget support like “PPP credits” or capital grants to defray contracting agency costs. Such incentive mechanisms assign a value (implicitly or explicitly) to the benefits to be obtained by the Government and society generally from PPP. Section 5 provides more detailed discussion of Government support for PPP.

The Government needs to decide whether Government support would represent value for money, should it be provided, if so how much, when, by whom and on what conditions. In the Netherlands and South Africa, the amount of direct fiscal support to a project can be as much as 100 per cent of the cost

Box 3.5: Cost of Public Versus Private Capital

It is often assumed that public capital is cheaper than private capital, but the two are difficult to compare—the cost of public debt is often (though not always) cheaper than private debt, but the actual cost of public capital should include the hidden risk premium of the implicit guarantee of taxpayers for public debt (the taxpayer risk making the debt cheaper). The equivalent risk premium is already built-in to the cost of private debt. The actual cost of public capital should also include the opportunity cost for the country of using its capital for different purposes. Chile, for example, applies a “social discount rate” when it uses its capital for infrastructure as compared to other sectors that would be less likely to attract private financing

Source: Klein, « The risk premium for evaluating public projects », Oxford Review of Economic Policy, vol. 13, no. 4 at 29 (1997). and McKinsey Global institute, “Infrastructure productivity: How to save \$1 trillion a year” (January 2013) at 25.

Box 3.6: The Indian PPP Institutional Framework

In 2005 the Cabinet Committee on Economic Affairs (CCEA) of India established the procedure for approval of public private partnership (PPP) projects, and the establishment of a Public Private Partnership Approval Committee (PPPAC). The PPPAC is constituted with Secretaries of MoF's Department of Economic Affairs (a DEA), the Planning Commission, MoF' Department of Expenditure, Department of Legal Affairs and the Secretary of the department proposing the project. The DEA Secretary chairs the PPPAC. A PPP cell was established in the DEA and undertakes the appraisal on behalf of the PPPAC, screens identified proposals for funding under the India Infrastructure Project Development Fund (IIPDF) and provides an advisory function to support state cells and municipalities.

Source: Dachs, International Benchmark Comparator Report, February 2013.

of the project—usually in the form of an availability payment made over the life of the facility. Such high levels of direct fiscal support are common for education and health facilities and Government accommodation PPPs. In India, the Government provides direct fiscal support of up to 40 per cent of cost or the amount needed to make them commercially viable (whichever is less), provided the project is justified on a cost-benefit basis. In contrast, many Government officials believe that PPPs should be largely self-funded, with infrequent and strictly limited use of direct Government support. The unintended consequence of this approach is that opportunities to stretch public funds and increase their impact are lost, time is wasted in preparing projects that never proceed because direct fiscal support is unavailable, yet projects still continue to obtain hidden subsidies through contingent support.

3.3 PROJECT SELECTION

The committees that make PPP decisions in successful countries have a value-for-money ethos, viewing PPPs primarily as a way to increase the total value

of services to the public, and not as a substitute for public finance. For example, in the Philippines, the National Economic Development Agency (NEDA) presents all relevant information to a powerful committee of ministers (including the Department of Finance and the sector ministry), who decide simultaneously on whether a project should go ahead, whether it should be a PPP, and what fiscal support it should be allocated.

3.4 PROJECT PREPARATION

A properly prepared project can only be achieved by the investment of time and resources in project development. The Government will need to form a project team, with appropriate skills, focused on the transaction. Many of these skills can be bought in through short term contracts and transaction advisers, though the project team will need the capacity to manage those advisers and the underlying issues to be resolved.

The contracting agency will need experienced and professional financial, legal, technical, insurance

Box 3.7: The UK's Erstwhile PPP Unit

Partnership UK (PUK) was formed by the UK Government in June 2000 following the recommendation in the second Sir Malcolm Bates review of 1999, and absorbed back into HM Treasury in 2012. It was a PPP, majority owned (51%) by private sector shareholders and the remainder retained by Government (HM Treasury 44,6% and Scottish Executive 4,4%). PUK supported:

- individual projects before, during and after procurement—by using its commercial experience and expertise.
- Government in developing policy and monitoring compliance—by using its market knowledge to ensure that outputs are effective and practical.

PUK financed itself by charging fees to the public sector for its services, benchmarked against private advisory companies.

Source: www.treasury.gov.uk/public-private-partnerships.

Box 3.8: The Challenges of Large Demonstration Projects

In Russia, the Government of the City of Saint Petersburg decided to launch the Western High Speed Diameter toll road as a large, single project with project costs exceeding Euro 12 billion in 2007. The subsequent tender process resulted in a single bidder, due primarily to the size of the project. After efforts at negotiation, the City chose to cancel the bidding process, restructure the project, and retender based on smaller phases of the project with more creative use of available financing, which led to the successful implementation of the project.

and other advisers when identifying, designing and procuring a project. Each of these advisers will be subject to different agendas and incentives which will influence the nature of their advice and the ease with which the Government will be able to manage their involvement. The project team (possibly through the PPP institutions) should have access to expertise in managing such advisers. To provide capacity to the teams, the United Kingdom arranged for secondment of staff from commercial banks and law firms with expertise in project finance into their PPP unit. South Africa and Egypt initially hired long-term expert consultants who had experience in successful PPP programs to work in their PPP unit to improve access to global best practices.

3.5 DEMONSTRATION PROJECTS

There is no substitute for experience. Most countries with successful PPP programs adopt a “learn-by-doing” approach, using the experience with early projects to improve the PPP framework. Equally, most of these countries experienced problems with their early projects, but they learned from these and revised their rules, policies and guidelines to avoid repeating those same mistakes. For example, in South Africa, the initial project scope specified for the first maximum security prison procured on a PPP basis proved to be fiscally unaffordable. As a result, the project required two years of design and scope changes after the preferred bidder stage was reached to correct this. Learning from this experience, the PPP guidelines now require the strict testing of fiscal affordability at the earliest stage of project preparation.

Governments are well advised to select viable, strategic projects to test their PPP framework. In implementing such projects, they will identify legal and institutional gaps and other opportunities to improve the framework. These early projects also send a clear message to the market that the Government is serious about PPP, and is adopting a reasonable model for risk allocation.

There is a tendency to select early PPP projects that are large, complex and politically popular (“transformational” projects). This is generally a mistake. PPP is a difficult structure to adopt, and large complex projects can add to that difficulty. Early projects create precedent that will apply to later projects, and create expectations amongst investors. These early projects should therefore be:

- Of sufficient size to attract experienced PPP investors, but not so large that they are overly complex, in fact smaller projects may be better
- well developed, i.e. feasibility study done or agreed, with sufficient funding and staffing for preparation, and
- politically strategic, but not so high profile that political interference is likely.

3.6 PREPARATION OF GOOD PRACTICE CONTRACTS AND BID DOCUMENTS

The standardization of risk allocation and contract terms helps reduce the cost of financing and project development. The standardization achieved in the UK¹⁷ and South Africa¹⁸ demonstrates the benefits available, including the reduction of time and cost of procurement. They also demonstrate the need for these provisions to evolve over time, as investors and lenders become more comfortable with the PPP framework and program.

The Philippine national planning agency revised its model PPP agreements for light rail, water, airport, and information technology outsourcing

¹⁷ www.hm-treasury.gov.uk/documents/public-private-partnerships/ppp_index.cfm.

¹⁸ www.ppp.gov.za.

projects on the basis of lessons learned from prior deals, international best practices and in conformance with the applicable rules and regulations for PPPs. The Netherlands has standard contracts for roads, schools and Government buildings. South Africa issued in 2004 a set of “Standardized PPP Provisions”. India has developed model concession agreements for its national and state highway, port, airport and passenger and freight rail projects.¹⁹

Colombia does not utilize standard or model PPP contracts, but it has established broad policy guidelines with respect to risk allocation for PPP projects involving transport, energy, communications and water and wastewater. It also has developed risk matrices for each of these sectors specifying which risks are to be assumed by the public and private partners, and the underlying contracts when prepared must reflect this information.

Standardization should be implemented gradually, using an iterative process for market feedback.

3.7 VALUE FOR MONEY

“Value for money” (VfM) is a measure of the net value that a Government receives from a PPP project. The assessment of VfM helps the Government decide whether a project should be implemented as a PPP and how much support the Government should provide to that project. Assessing VfM is as much an art, as a science, given the various and changing concepts of “value” that the Government will want to access through PPP.

Various approaches and models endeavour to quantify VfM, in particular through public sector comparators (see Box 3.11), cost benefit analysis and shadow models (where a financial model is developed from the bidder’s perspective to test likely bidder concerns). Best practice uses such quantitative analysis as important data, but looks to a qualitative analysis to respond to all relevant parameters rather than seek measurable accuracy in assessment. (see Box 3.10)

VfM is often used as an ex-post rationalization of a political decision to implement a project under PPP.

Box 3.9: Lessons from London Underground - Allocating Too Much Risk to The Private Sector

“Contracts that were supposed to deliver 35 station upgrades over the first three years in fact delivered 14—40% of the requirement; stations that were supposed to cost Metronet SSL £2 million in fact cost £7.5 million—375% of the anticipated price; by November 2006, only 65% of scheduled track renewal had been achieved. They have ended in collapse and chaos. It was a spectacular failure.”

“The Government should remember . . . that the private sector will never wittingly expose itself to substantial risk without ensuring that it is proportionally, if not generously rewarded. Ultimately, the taxpayer pays the price.”

Source: House of Common, Transport Committee, “The London Underground and the Public–Private Partnership Agreements,” Second Report of Session 2007–08, HC 45 (January 2008).

Box 3.10: The UK’s Latest Views on Quantitative Versus Qualitative VfM

The current approach to appraisal of PFI sets out that qualitative considerations—viability, desirability, achievability—should frame the approach to the quantitative assessment. The intention is that the quantitative assessment should form part of the overall value for money judgement rather than be seen as a stand-alone pass/fail test; neither the quantitative or qualitative assessment should be considered in isolation. The UK National Audit Office has, in the past, expressed concerns that too much weight is given to cost modelling; they have put considerable emphasis on the fact that financial appraisal is just one part of the overall assessment of the contracting approach, and have sought to discourage appraisers striving for disproportionate levels of accuracy.

Source: Infrastructure UK, “A new approach to public private partnerships” (December 2012).

This can jeopardize the sustainability of the project and PPP program. A robust VfM exercise at the time of project selection and procurement can protect a project from ex-post challenges.

3.8 APPROVAL PROCESS

A number of approval processes will apply to a PPP project. Approvals help raise key questions

¹⁹ Available at: <http://infrastructure.gov.in/mca.htm>.

Box 3.11: Public Sector Comparator (PSC)

A comparison between the cost of public delivery of the project and that through PPP can provide a useful mechanism is assessing value for money. But a PSC is difficult to assemble with any accuracy. In order to assess PSC properly, full information is needed on how the project would be implemented by the public sector, including actual cost of construction, cost of operation, cost of financing and risk borne by the public sector (which is difficult to calculate with any accuracy).

For further discussion of PSCs, see the UK Treasury website, www.treasury.gov.uk.

and issues during preparation of the project. They are important for quality control but also for buy-in from different agencies, achieving greater ownership and certainty for investors. But these layers of different agencies with approval rights can complicate the process. To the extent possible these approval requirements should be streamlined, to facilitate efficient application and approval, reduce the cost of approvals, and fast-track the investment process.

The following describes a few of the key parties that often have approval rights and the points in the project process at which such approvals are usually required.

- *Sector line ministry* in particular during project selection, feasibility verification (based on the feasibility study), before issue of bid documents, award/financial close, and renegotiation.
- *Government fiscal risk management authority* in particular during feasibility verification

(based on the feasibility study), before issue of bid documents, award/financial close, and renegotiation.

- *Sector regulator* will be responsible for some combination of economic impact (e.g. tariff levels, cross-subsidization amongst consumers and cost allowances), environmental impact and consumer protection. Approval rights arise during project selection, award/financial close, and renegotiation.
- *Procurement agency* will be responsible for monitoring the use of transparent, competitive procurement. Approval rights arise before issue of bid documents.
- *Environmental agency, land agency, Attorney General, etc.*—there are a variety of agencies with regulatory authority over specific issues, with approval rights during feasibility verification (based on the feasibility study), before issue of bid documents, award/financial close, and renegotiation.

Box 3.12: Delusion and Deception in Risk Assessment

As human beings, our risk assessment tends to be influenced by personal beliefs or biases, for example:

- underestimating the time and cost required to complete a task,
- believing we understand risk better than we really do,
- underestimating risks associated with familiar tasks, for example traffic accidents while driving to work and slipping in the bathtub,
- validating prior decisions.

There may be collaboration in these influences. This collaboration may have pure motives, for example exaggerating the benefits and underestimating costs and time to help decision-makers justify a project they believe is important. And yet, this deception ends up costing the taxpayer, since risks that are ignored are not managed.

Source: Flyvbjerg, Garbuio and Lovallo, Delusion and deception in large infrastructure projects: Two models for explaining and preventing executive disaster, *California Management Review*, vol 51, no 2, winter 2009; Delmon, *Project Finance, BOT Projects and Risk* (2005); Delmon, Increasing the efficiency of risk allocation in project financed public private partnership (PPP) transactions by reducing the impact of Risk Noise, *ICLR* (Winter 2014).

4

Procuring and Implementing Transactions

We can easily forgive a child who is afraid of the dark; the real tragedy of life is when men are afraid of the light.

—Plato

In amongst the roles played by PPP institutions, this section will review methods for the Government to support project preparation and implementation, following pre-feasibility and feasibility studies, project preparation, the procurement process for PPP projects, and the implementation and monitoring of PPP projects.

Competitive procurement of PPP involves careful preparation, reviewing risks and their allocation, identifying market requirements and creating a competitive process for selection of the right private partner. In its most basic form, the tender (or bid) process involves a party offering a project to the market and asking for bids from parties interested in performing the project, or some part of the project. Tendering (or bid) procedures are meant to achieve efficiency, manage costs, maintain quality, encourage expediency and maximise value for money. PPP transactions take time to prepare, and need the attention of experts to ensure that risks and financing are managed properly and efficiently and taken to market in a form and manner designed to attract as many high quality bidders as possible and thereby keep costs down and improve delivery.

Figure 4.1 provides a depiction of institutional functions and maps them against the different phases of project development, as per the PPP program in South Africa.

4.1 INCEPTION/PRE-FEASIBILITY/ PRELIMINARY VIABILITY STUDY/OUTLINE BUSINESS CASE

A pre-feasibility study (also known as an outline business case or preliminary viability study) tests the fundamentals of the project, based on a preliminary technical survey identifying key constraints and

Key Messages for Policy Makers

- *Do not cut corners in procurement.* It may seem easier to enter into direct negotiations instead of using competitive procurement, but it isn't. It takes longer and costs more money. Maximize competition (where possible) through good, transparent, competitive procurement.
- *Invest in preparation.* PPP preparation takes time and money, if done well.
- *Be clear to bidders about what you want.* Indicate clearly what results, milestones and indicators you want the investor to achieve, in particular in the bid evaluation criteria and their weighting. Help bidders to give you what you want, don't make them guess.
- *Be cautious when selecting the winning bid.* If a bid seems too good to be true (financially, technically or otherwise), then it probably is.

assessing the basic technical and financial project fundamentals such as site selection, concept design and possible forms of implementation, revenue and financing. A first level financial model will be developed at this stage, to test the viability of the project and the potential appetite of investors. This is an essential stage of project development, to avoid wasting preparation costs on projects that do not satisfy this basic test of viability. As part of the pre-feasibility study, the contracting agency makes a preliminary assessment of value for money,²⁰ which tests the value provided by PPP.

Once a preliminary decision to undertake the project through private investment has been made, a feasibility study is undertaken to identify key project issues and constraints.

4.2 VIABILITY/FEASIBILITY STUDY/FULL BUSINESS CASE

The decision on implementation of a project through PPP will follow a “viability” or “feasibility” study (also known as a “full business case”), which is a more detailed version of the pre-feasibility study. The contracting agency performs a feasibility study to commence project structuring and key risk allocation decision making. It is at this stage that the fundamental design of the PPP solution is defined.

Figure 4.1: The PPP Project Cycle



Source: Republic of South Africa website.

Failure to implement the different stages of project preparation properly, with sufficient time, funding and expert advice has doomed many a PPP project and program; this preparation process should not be curtailed. As in most such exercises, a balance needs to be found between the time and expense of the “perfect” feasibility study, and a feasibility study that addresses enough to meet market, contracting agency and Government approval requirements.

²⁰ For further discussion of value for money, see section 3.2.5.

Box 4.1: Optimism Bias or Bad Incentives—How Planning Goes Wrong

Planning and forecasting need to reflect benefit to the Government, through cost-benefit or value for money assessments. But such assessments tend to involve incentives for those performing them to emphasize benefits and de-emphasize costs, whether consciously or not.^a There is a similar bias towards new build, rather than refurbishing what exists and maintaining it properly. Maintaining a road properly is more than three times less expensive than maintaining it poorly and rebuilding later. But the socio-political incentive is to build something big and new that can carry the name or be identified with a politician or political party. Khan and Levinson (2011) highlight the failure in the US national highway system to maintain roads properly due in part to the tendency for federal monies to be allocated to new build projects rather than maintenance or refurbishment.^b The Private Infrastructure Investment Management Center in South Korea routinely rejects 46% of proposed projects (compared with 3% before its creation) at a savings of 35% to the Government on poorly planned or selected projects. Similarly, Chile's national Public Investment System rejects 25–35% of projects proposed.^c

Source: McKinsey Global institute, "Infrastructure productivity: How to save \$1 trillion a year" (January 2013).

- a See Flyvbjerg, "Survival of the unfittest: Why the worst infrastructure gets built—and what we can do about it," *Oxford Review of Economic Policy*, volume 25, number 3, 2009; McKinsey Global institute, "Infrastructure productivity: How to save \$1 trillion a year" (January 2013).
- b Kahn and Levinson, "Fix it first, expand it second, reward it third: A strategy for America's highways," *The Hamilton Project discussion paper 2011-2013* (February 2011); McKinsey Global institute, "Infrastructure productivity: How to save \$1 trillion a year" (January 2013).
- c McKinsey Global institute, "Infrastructure productivity: How to save \$1 trillion a year" (January 2013).

Interested parties, such as potential investors, funders or contractors, may offer to develop, or may produce of their own accord, "feasibility studies". Government needs to be cautious. Even with the best of intentions, such studies will be biased towards the interests and context of the proponent. Government will need its own, independent study to ensure feasibility is properly tested, key choices are well founded and the Government has critical information needed to negotiate with eventual investors and funders. Following the feasibility study, and associated approvals, the contracting agency is ready to commence the tender process.

Having the project approved as a PPP at this advanced stage of development ensures political buy-in of the process before the Government and potential bidders start investing further in project development.

4.3 DIRECT NEGOTIATIONS AND UNSOLICITED PROPOSALS

Governments often receive proposals directly from private investors. These proposals can be a good source of innovative ideas for the Government, and can help Governments identify new project concepts. However, unsolicited proposals are difficult to manage and can be a source of significant mischief.

Direct negotiations generally take longer, are more expensive and are more likely to fail than projects procured through competitive processes.²¹ Directly negotiated arrangements are also more vulnerable

²¹ See inter alia: "Getting value for money from procurement," National Audit Office (UK); Inadomi, *Independent Power Projects in Developing Countries: Legal investment protection and consequences for development* (2010).

Key Messages for Policy Makers

- *Select good projects.* Garbage-in-garbage-out; say "no" to bad projects
 - Select robust, viable projects for PPP, these are more likely to be financed on a competitive basis and are therefore more likely to provide value for money. Projects suffering from bad design, dubious demand or weak fundamentals (even if politically popular) are more likely to fail, and may weaken the entire PPP program in the process.
 - If a project needs Government support, get approvals early to avoid wasting time and money on projects that do not meet viability and value for money criteria, and the awkward position of Government rejecting support for a project only after preparation.
 - A good, transparent selection process (for commercial rather than political reasons) can reassure investors and increase competition. Projects selected for political reasons or priorities will create a perception of increased political risk amongst investors.

Key Messages for Policy Makers

- *Prepare the Government to play its part from project development to expiry.* Even where a comprehensive PPP is envisaged, the Government will play an essential role in monitoring and regulating the project and the sector.
- *Be ready for challenges.* In any long-term relationship, change happens. PPP is, above all, a partnership, and it needs to be designed with challenges, changes and resolution in mind. Problems need to be elevated to appropriate levels of management before they become disputes or worse.
- *Consider all stakeholders.* PPP will have a direct influence on some stakeholders (in particular employees and management) and may raise political or philosophical concerns amongst many more. While absolute consensus will never be reached, the Government needs to consult widely, understand fundamental concerns and address them.

to challenges by new Governments or opposition groups—without the validation of a transparent, competitive process, direct negotiations are more vulnerable to claims of bias, corruption, incompetence and inappropriate use of Government resources.

Where permitted, the circumstances allowing the award of the project without competitive procurement should be limited. The cases where this might be acceptable would satisfy most or all of the following criteria:

- where the project is of short duration and a small value
- the project is critical to national defence or national security
- there is only one possible source of the services (due to the skill set of the provider or intellectual property)
- where there have been repeated efforts to implement a competitive process, but with no success, yet there is one party willing to undertake the project on the same terms that failed to attract competition

Box 4.2: Benchmarking

Where a project is not subject to competitive pressures, or that competition is insufficiently robust, the Government should submit that project to benchmarking to verify that the price represents best value as compared to similar projects, in the sector and in similar countries. This can be a challenging process where equivalent projects are not readily available, or where relevant information is not available.

Whenever a project is proposed to be awarded without competitive procurement, the mechanism to apply for such a waiver should be managed by an appropriately high level authority. The decision process should be made public and transparent; to allow other stakeholders to comment if they have issues, and there should be a mechanism for those disgruntled stakeholders to appeal against the decision. These mechanisms help protect the decision and the project from vulnerability to legal and political challenge.

Where competition is not possible or practicable, legislation often provides for market testing to ensure that the pricing and terms agreed for an unsolicited proposal meet market standards (are consistent with what the Government would have achieved through competition). A robust, independent feasibility study is invaluable in such circumstances. Wherever possible, unsolicited proposals should be subjected to competitive bidding, in pursuit of the best deal for the contracting agency and to manage the perception of corrupt practices through transparent competition.

Some countries reject unsolicited proposals outright, providing no benefit or compensation to those offering such proposals. In particular in countries without the resources and sophistication to manage unsolicited proposals, this offers a robust method to avoid the complications and dangers of unsolicited proposals; but also deprives the Government of the advantages.

Mechanisms have been developed to encourage unsolicited proposals, while also ensuring that competitive tendering is used, where possible,

Box 4.3: Unsolicited Bids in Colombia

The Ministry of Transport, DNP (the planning agency) and the MoF enacted detailed regulations regarding the acceptance of unsolicited proposals from the private sector.^a If accepted as a viable project, an unsolicited proposal must then go through a competitive, open procurement.^b The proponent participates in this selection process like any other bidder. If the proponent's bid is not selected, however, then the winning bidder must reimburse the proponent for certain of its expenses, as approved by the responsible Government agency prior to the start of the tender process. In such case, the proponent is responsible to the winning bidder for the quality of the relevant studies.

a MOT Decree No. 4533 of 2008.

b See requirements of Laws 80 of 1993 and 1150 of 2007.

when selecting the best investor.²² These mechanisms involve a careful review of such unsolicited proposals to ensure they are complete, viable, strategic and desirable. The project is then put out to competitive tender, with the proponent of the unsolicited proposal receiving some benefit, for example:

- proponent pre-qualified automatically,
- a bonus on the proponent's scoring in the formal bid evaluation (i.e. additional points allocated to the proponent's total score when its bid proposal is evaluated),
- a first right of refusal, enabling the proponent to match the best bid received (also known as the "Swiss challenge"), in some cases only where the proponent's bid score is within a defined margin of the best bid,
- the right to automatically participate in the final round of bidding, where there are multiple rounds of bidding (the "best and final offer" system), and
- compensation paid to the proponent by the Government, the winning bidder or both.

The unsolicited proponent is often viewed as having an unfair advantage, so any preference given (such as a right of first refusal or bonus during bid evaluation) may stifle competition.²³ A more robust approach is to use competitive tendering, but without any advantage to the unsolicited proponent. Instead a fee is paid to the proponent if he does not win the bid, as compensation for the value added by his efforts to develop the project. The fee should be sized to reflect actual benefit of the proposal to the Government.

4.4 PRE-QUALIFICATION

The bidding process is generally lengthy and costly, for the bidders and for the contracting agency. In order to manage the cost and time outlay, the contracting agency may wish to prequalify those parties most likely to provide an attractive bid, and avoid

²² Hodges and Dellacha, *Unsolicited Infrastructure Proposals: How Some Countries Introduce Competition and Transparency An International Experience Review*, 2007.

²³ This is not the case in countries like Chile, with a very sophisticated regime that gives confidence to other bidders that the proponent will not have an unfair advantage in the process.

Box 4.4: Prequalification Criteria for an Airport Concession

Each sector and project has its own specificities. For example prequalification criteria for an airport PPP may include:

- level of owned total assets in excess of a set amount
- recent experience managing the construction and operation of an airport of similar size and complexity in a similar market
- recent experience raising similar amounts of debt and equity
- exclusion of air carriers, or of companies owned by air carriers, or of operators of airports located close to the site (e.g. within 800 km) (which would create a natural conflict of interest)

Clearly these criteria will need to be adjusted based on market context.

the time and cost of managing bidders who do not have the fundamental qualifications or financial substance that would enable them to undertake the project. Prequalification also encourages good bidders, who will prefer a smaller field of equally qualified competitors.

4.5 BID

The contracting agency provides the prequalified bidders with tender documents (including project documents and technical specifications) and access to relevant data. Bids received will be evaluated against specified criteria. The criteria need to be described thoroughly in the bidding documents to help bidders understand the contracting agency's needs, and to improve the quality of bids received.

4.6 SINGLE BIDS

Even in the most sophisticated markets, creating investor appetite can be a challenge. Even before the financial crisis, some 30% of PPP projects in the UK only received 2 bids.²⁴ The procurement process should put the contracting agency into a strong negotiating position if there is only one bidder, limiting the opportunity of that bidder to hold the contracting agency hostage. The contracting agency needs to be prepared to start the bidding process over if it is not happy with the bidder's proposal. Where a single

bid scenario is encountered, benchmarking of the bid may be a useful mechanism to help the Government understand if it is getting good value, and to help reassure other stakeholders that the lack of competition is not a fatal flaw in the process.

4.7 PREFERRED BIDDER

Once bids are received, the contracting agency will evaluate those bids and select the preferred bidder. The contracting agency will negotiate with the preferred bidder any open issues (to the extent permitted the bid documents or by law), finalize the commercial and financial arrangements, award the project, sign the concession agreement and other key contracts (subject to the conditions precedent discussed below), and reach financial close. More than one preferred bidder may be selected for additional rounds of competition, for example through best and final offer (BAFO—see Box 4.6) or competitive dialogue (see Box 4.7, below). Additional rounds need to be carefully managed, to maintain transparency, avoid any perception of favouritism or corruption, and limit the added cost and delay such a process implies.

Lenders will not be finally committed to the project until financial close is achieved. Before financial close, lenders will want to confirm that the risk allocation for the project is “bankable”, a general term referring to the level of comfort that a lender will require from a project given the context of the project (sector, location, size, etc.).²⁵ The lenders will then

Box 4.5: Sample Bid Evaluation Criteria for an Airport PPP

For an airport PPP, bid evaluation criteria may include:

- A technical solution compliant with the airport masterplan and with specifications provided.
- A legal solution compliant with bid documents.
- A financial proposal indicating the extent of Government funding, investment, or guarantee needed or the share of project revenues.
- A financing plan showing how and from whom the bidder intends to mobilize debt, equity and other financial instruments to fund the project and how much due diligence has been completed.

Source: Ricover, Cuttaree and Delmon, *Airport Development through Public Private Partnerships: Guide for decision makers* (World Bank, 2013).

Box 4.6: BAFO

The contracting agency may choose to include additional stages of competition, for example reducing the competition to two bidders who will then be asked to further refine their bids and submit a best and final offer (BAFO), further to which the contracting agency chooses the preferred bidder. This process allows the contracting agency to use the available competitive pressure to further motivate bidders, and possibly obtain firm financing commitments.

²⁴ National Audit Office (UK), “Improving the PFI Tendering Process”, (March 2007).

²⁵ See Delmon, *Private Sector Investment in infrastructure: Project finance, PPP projects and risk* (2ed Kluwer International 2009).

agree with the project company and the Government a list of conditions precedent (CPs) that must be satisfied before the lending arrangements become final, and before first drawdown can be made.

4.8 MANAGEMENT/MONITORING OF IMPLEMENTATION

Financial close is not the end of the process for the Government; it is only the beginning. Managing the PPP agreement starts at the inception phase of the PPP project cycle, designing appropriate solutions and managing input from different advisers. It continues through the selection of the investors and then during implementation of the project. Government must allocate resources and staff to ensure that the project is well managed during implementation, in particular where variations, renegotiation and refinancing are concerned. Each of the issues discussed below needs to be considered by the Government before starting procurement, to ensure processes are in place, established by contract and/or by law and properly funded.

4.8.1 The project team

During implementation, the project team must adjust to a rhythm and access to technical capacity needed to ensure that the contracting agency and project company comply with their obligations in the manner and time required. The regime established needs to conform to local practices, and monitoring and control functions to ensure that the Government complies with its obligations that any non-compliance by the project company is caught

Box 4.7: Competitive Dialogue

The European Union uses a “competitive dialog procedure” which allows Governments to enter into a dialogue with prequalified bidders before finalizing the tender documentation. It allows structured discussions with each of the prequalified bidders and helps identify key issues and amendments needed for the project.^a

^a European PPP Expertise Centre, *The Guide to Guidance: How to Prepare, Procure and Deliver PPP Projects* (European Investment Bank 2012). www.eib.org/epec/resources/guide-to-guidance-en.pdf

early and any conflicts are addressed before they become disputes. These requirements change over the life of the projects, from monitoring completion and managing variation claims during construction, to regulating service delivery and operations, and finally expiry of the project, asset hand-over and decommissioning.

4.8.2 Operations manual

The operations manual will provide guidance on every aspect of the project implementation process, following each element of the PPP agreement including standard form documentation, model process schedules and other practical assistance for project implementation. The Government can use the transaction advisers it appoints to help procure the project to help it prepare the operations manual.

4.8.3 Monitoring performance

The Government may be assisted in its monitoring/management function by third parties. For example, an independent specialist may be appointed under the contract to act as the monitor of compliance with contract obligations by the parties.²⁶ Equally, the sector regulator (e.g. the water sector regulator) will

Box 4.8: Squeezing the Stone

The UK has identified potential savings during implementation, including

- Renegotiating the scope of contracts, removing services no longer required.
- Improving risk allocation by taking back energy consumption risk and improving energy efficiency through improved technology and using government purchasing power to lower utility and consumables costs.
- Cutting waste by finding alternative uses for under-utilised assets
- Avoiding additional costs through better contract management.

Source: Infrastructure UK, “A new approach to public private partnerships” (December 2012).

²⁶ Tremolet, Shukla and Venton, *Contracting Out Utility Regulatory Functions* (World Bank 2004).

be monitoring the project company's compliance with their obligations under law, which may well coincide with their obligations under the relevant contracts. The difficulty with this approach is the need for the regulator to operate in accordance with its mandate, with the usual discretion given to regulators. Often, this discretion cannot be limited (or "fettered") and therefore the regulator must comply with his legal mandate first and the contractual role as a secondary function.

4.8.4 Refinancing

After completion of construction, once construction risk in the project has been significantly reduced, the project company will generally look to refinance project debt at a lower cost and on better terms, given the lower risk premium. This refinancing process can significantly increase equity return, with the excess debt margin released and the resultant leverage effect. While wanting to incentivize the project company to pursue improved financial engineering, in particular through refinancing, the contracting agency will want to share in the project company's refinancing gains (for example in the form of a 50–50 split), and may or may not want the right to insist on refinancing when desirable.

4.8.5 Selling down equity

Many of the key sponsors are not normally long-term equity infrastructure investors, for example the construction companies who are often the key investors in road PPP, or the equity funds that look for investments with short—medium term (3–7 year)

exit opportunities. Investors will therefore look for the right to sell down their equity positions as soon as possible. The contracting agency will want the shareholders to remain invested until key project risks have been addressed, in particular construction risks. Some time after completion of construction (usually 1–3 years) investors are generally permitted to sell-down part of their equity. Strategic shareholders are those who provide critical skills/inputs to the project company. The contracting agency will want to ensure that strategic investors retain sufficient financial interests in the success of the project, to align their interests, for a period long enough to ensure that design and construction meet requirements.

4.8.6 Dispute resolution and renegotiations

PPP projects have characteristics propitious to recurrent disputes;²⁷ they represent long term, complex commercial and financial arrangements, which may require renegotiation to resolve. Renegotiation is often perceived as failure, as a fundamental flaw in the project, or in PPP generally. This perception arises in particular from poorly managed or implemented renegotiation processes.

²⁷ Straub, Laffont, and Guasch, *Infrastructure Concessions in Latin America: Government-led renegotiations, 2005*. PPP database (preliminary figures): for 2003, 34% of contracts (by investment amounts) in the water sector were classified as distressed and 12% were cancelled, in transport 15% were distressed/ and 9% cancelled), while in energy 12% were distressed and 3% cancelled. See <http://PPP.worldbank.org>.

Key Lessons for Policy Makers

- *Be proactive.* Establish mechanisms intended to catch disputes as early as possible. Early in the process, options are varied, relative cost is low, and the likelihood of immediate value-added resolution is higher.
- *Facilitation can help.* Softer processes are designed to use and develop relationships as the basis for finding mutually satisfactory solutions and can work better than more formal processes.
- *Renegotiation can be an opportunity,* and can improve the PPP arrangements and protect the poor, if it is contemplated in advance, transparent and well managed when needed.
- *Get good advice.* Do not try to manage disputes or renegotiations with internal staff alone, no matter how good they are. Get the best, external advice. It will cost money, but will save money in the long run.

There is no doubt that renegotiation is a difficult and easily abused process, but it is typical for long term arrangements (be they PPP contracts, commercial partnerships or marriages) to face change or conflict and need adjustment to address new information and circumstances. Renegotiation is a natural part of most projects and can be an opportunity to adjust the terms of a project to address the needs of the project (and the public) and actual circumstances encountered by the parties, to the benefit of the parties and the intended beneficiaries of the project. PPP projects must therefore be designed to address change and conflict quickly and effectively, and to facilitate renegotiation in a balanced, transparent manner in accordance with the spirit of the project.²⁸

4.8.7 Expiry, termination and handover

After delivery, whether the project is terminated early, or expires in accordance with expectations, the Government will need to manage the exit phase, for example the Government team will need to evaluate exit options, advise the Government on agreement termination/expiry and manage termination/hand-over. The project implementation team will need access to appropriate expert advice and support to ensure that termination and hand-over are well managed.

²⁸ Delmon and Phillips, "Renegotiation of Private Participation in Infrastructure and the World Bank" (World Bank, 2007).

5

Using Public Support for PPP

You miss 100% of the shots you don't take.

—Wayne Gretzky

Governments can and should use public resources to support and enable PPP programs where this provides value for money as an integral part of the PPP framework. Figure 5.1 maps out key opportunities to use public money to mobilize PPP, including through the project development cycle, supporting project preparation, through the bidding process, investment mechanisms that can support project financing and finally contingent support to reinforce and target the incentives fundamental to the project revenue stream and possibly refinancing.

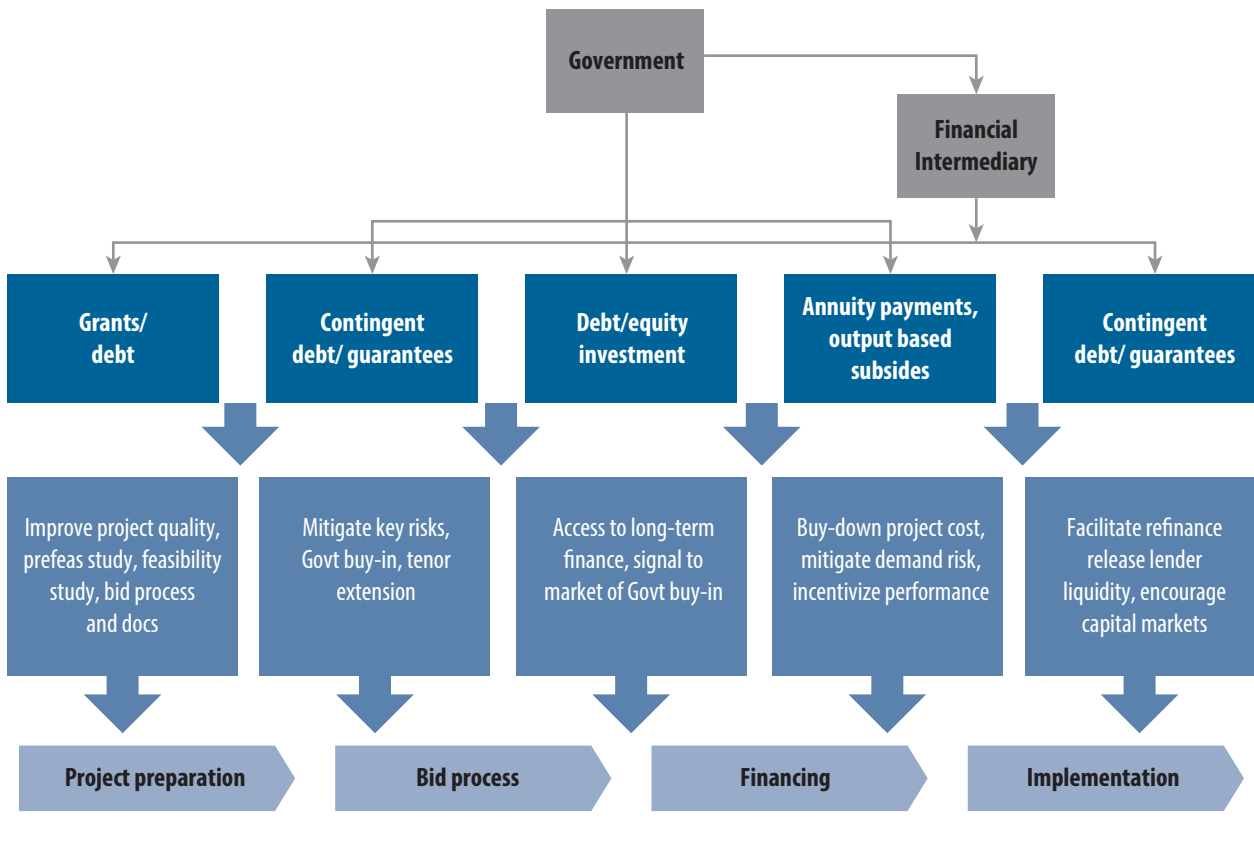
Moving chronologically through the project process, the following are some of the key areas the Government can support to help implement PPP:

- Project preparation—funding and technical support for feasibility studies, hiring and managing transaction advisors.
- Capital grants and in-kind support—for example offsetting construction costs, acquiring land, rights of way, etc.
- Debt or equity into the project—to supplement available private capital.
- Contingent support—to address key project risks, for example guarantees of demand risk, foreign exchange risk or payment risk.
- Revenue support during implementation,—e.g. as key milestones are achieved, possibly as a feed-in/shadow tariff or availability payment.

5.1 THE FUNDAMENTALS OF PUBLIC SUPPORT

The Government will need to consider carefully which projects to support, how much support to provide, the terms of such support (in particular, incentives to create and how to maximize leverage of private investment) and how to ensure that support is properly managed.

Figure 5.1: Mechanisms to Encourage PPP



Public funds should be targeted toward the most strategic, economically viable and feasible projects.

There is a temptation to approach a project assuming that no Government support will be needed, and to only contemplate such support when negotiations with investors and lenders fail without it. However, this results in an ad hoc support package, developed

when the Government’s negotiating strength is low; achieving maximum leverage and minimum exposure will be even more difficult. Allocation of Government support must be decided and announced before the bid date to maximize benefits for the contracting agency, and avoid perceptions of discrimination by those who would have bid had they known that such support was available.

Box 5.1: The UK’s Erstwhile PFI Credits

Until relatively recently, the UK Treasury allocated PFI Credits for both local Government and central level Government departments—a specified amount of funding for a specific project over a period of time beyond that of the immediate budget allocation framework. It allowed the local authority (or department in the case of central Government) certainty as to a revenue stream from the central budget for meeting its obligations under a PPP agreement and provided a strong incentive for departments and local authorities to implement projects as PPPs. The use of PFI credits was heavily criticized for creating significant long-term liabilities for the Government. The program has been abandoned officially.

Source: www.treasury.gov.uk/public-private-partnerships (See also Box 5.7).

It is advisable for Government to consider Government support as a package—funded and contingent—to ensure that maximum leverage and optimal exposure (fiscal risk) is achieved.

The Government needs to be very careful about de-risking debt. To the extent debt is de-risked, incentives on lenders to ensure project success are diminished.

It is tempting to use available public support to simply improve those projects that do not achieve the levels of viability or feasibility required by private investors. To ensure the public support is not wasted on simply compensating private investors for failures in the Government's PPP framework, appropriate investments should be made in improving the framework for PPP in parallel with maximizing the effectiveness of Government support.

5.2 PURPOSES FOR PUBLIC SUPPORT

Public resources can be used to achieve a number of different goals associated with PPP projects or programs. The nature of the Government support instruments chosen will depend on the intended impact of that support, the volume and currency of liquidity (or other funding) available to the Government, the fiscal position of the Government and the financial gaps identified in the relevant PPP projects or program. Government support can:

- Improve access to and quality of services provided creating financial incentives to achieve Government strategic priorities (see Box).
- Improve quality of projects, which in turn improves competition, drives down prices and increases the likelihood of success of the PPP program. Funding mechanisms for project development are important to a successful PPP program, enabling and encouraging Government agencies to spend the amounts needed for high quality advice.
- Increased use of PPP. The benefits of PPP (efficient procurement, lifecycle improvements, well planned maintenance and service improvements)

Key Messages for Policy Makers

- *Government support* can improve financial viability and make a project more attractive for investors, but it *will not turn a bad project into a good one*.
- *Use Government support efficiently*, in a targeted manner, to ensure Government goals are achieved.
- Ensure funding mechanisms are properly resourced and incentivized to *avoid political capture or inertia*.
- *Avoid perverse incentives* created by Government support—ensure private and public are motivated to make the project a success.

Box 5.2: Targeted Support

Output or performance based subsidies or aid makes a clear link between the intended results and payment.^a While requiring evidence of the ultimate output (e.g. healthier children or improved industrial output) is impractical for a number of reasons, Governments can require the project company to perform a task or provide a service that achieves a stated objective before aid or subsidies are paid out, for example a specified number of additional poor households connected to the electricity grid and using the service. These outputs need to be targeted to ensure they achieve the desired impact (e.g. connections alone will not create an output unless the service delivery is sustainable).^b

^a Brook and Petrie, Output-based aid: Precedents, Promises and Challenges, <http://www.gpoba.org/docs/05intro.pdf>.

^b See generally www.gpoba.org.

Box 5.3: Project Development Funds (PDFs)

South Africa: The PDF began operations on 21 October 2003. It is a single-function trading entity (public account), created within the National Treasury. Disbursed funds may be recovered from the successful private party bidder when the PPP reaches financial close, as a “success fee”. The PDF is exposed to the full risk of the project not reaching financial closure. The PDF is capitalized by the South African Government, as well as donors.

India: The “India Infrastructure Project Development Fund” is a revolving fund which is replenished by the re-imbursment of investments through success fees earned from successful projects. The project development fund will cover up to a maximum of 75% of the project development expenditures incurred by the contracting agencies. The fund is capitalized by contributions from the Government of India and multilateral institutions.

may not be captured by the relevant contracting agency. Government support can provide the incentives required to motivate even reluctant users to implement PPP effectively.

- Reducing the amount of private finance needed.
- Improve opportunities for specific parties, for example local lenders and local equity investors, smaller investors and new/poor consumers.

5.3 FUNDED INSTRUMENTS

The most common form of Government support involves instruments that provide cash, assets or some other form of funding, often known as “funded” instruments, e.g. loans, grants, land, assets or equity. This is different from contingent support, where the Government support must be paid out or crystallizes only in certain circumstances, e.g. standby capital (debt, equity or grants), guarantees or indemnities.

Box 5.4: (Mis)use of the Term “Viability Gap Funding”

The Indian Government has created a mechanism to pool capital contributions for PPP transactions (open to many sectors, but used primarily to date to support the roads sector)—see Box 5.7 below. The popularity of this mechanism has resulted in the term “viability gap funding” entering the common parlance in certain circles as a generic term for all Government support or capital contribution programs. There is a strong risk of confusion with the Indian program (which involves only one form or, and approach to, Government support) and therefore this generic version of the term will not be used in this text.

Box 5.5: India’s Viability Gap Fund

In 2004, the Government of India launched the Scheme for Financial Support of PPPs in Infrastructure, now more commonly known as the Viability Gap Funding (VGF) scheme. VGF provides up-front capital grants at the construction stage. These grants may not exceed 20% of the project cost and are disbursed only after the private company has made its required equity contribution. Sponsoring ministries or state Governments may provide additional grants, but these may not exceed an additional 20% of the project cost. No economic cost benefit assessment is performed, relying instead on sector regulation and competitive procurement to identify the need for Government contribution.

www.pppindiadatabase.com

5.3.1 Grants / capital contributions

The Government may choose to provide funded support that does not give the Government an ownership interest, for which the Government does not charge interest and may not require reimbursement, often known as a contribution, subsidy or grant. The process for selecting which project will receive Government contributions should focus on the relative benefit of the project to the country given the amount of contribution required.

Similarly, it may be difficult to assess the amount of contribution for a given project that represents value for money. Many jurisdictions use competition to set the amount to be allocated, e.g. in India (see Box below) the procurement process uses the lowest Government contribution as the key criteria to select the winning concessionaire. Brazil, Colombia and Mexico use similar competitive pressure to identify the appropriate level of Government contribution to be provided. But this approach leads to some concern that politically motivated but unviable projects are being enabled through such contributions.²⁹ Russia’s Investment Fund allows the contracting agency to use a value for money analysis to set the level of contribution (using the competitive process to achieve additional advantages).

Box 5.6: Russia’s Investment Fund

The Russian Government allocates a line item in its national budget to support PPP and other regional projects with grants, managed by the Ministry of Regional Development, and referred to as the Investment Fund. These funds can cover up to 50% of the project capital cost, and are subject to a variety of rules and procedures on the condition of their allocation and use. To date, the Western High-Speed Diameter toll road (which reached financial close in mid-2012) is the most high-profile and largest recipient of Investment Fund contributions.

Some countries run their contribution commitments through state owned enterprises (who can roll budgeting and commitments over from one year to the next), for example the public power utility

²⁹ *Ibid.*

is often used to pay such contributions for power PPPs. In Mexico, Fondo Nacional de Infraestructura (Fonadin—see Box 6.7) is funded through capital set aside by the Government and revenues from existing public toll roads. It granted over \$1 billion worth of Government contributions to PPP projects during 2008–2009 alone.³⁰

Russia (see Box 5.6) has created a nominal fund in order to establish rules and regulations applicable to Government contributions, but the funding comes directly from annual budget allocations rather than a stand-alone fund. Colombia has a special mechanism for future budget allocations, while Brazil treats Government contributions as “interest payments” to mitigate the risk that annual legislative budget approvals might be delayed or rejected.³¹

5.3.2 Payments for services rendered

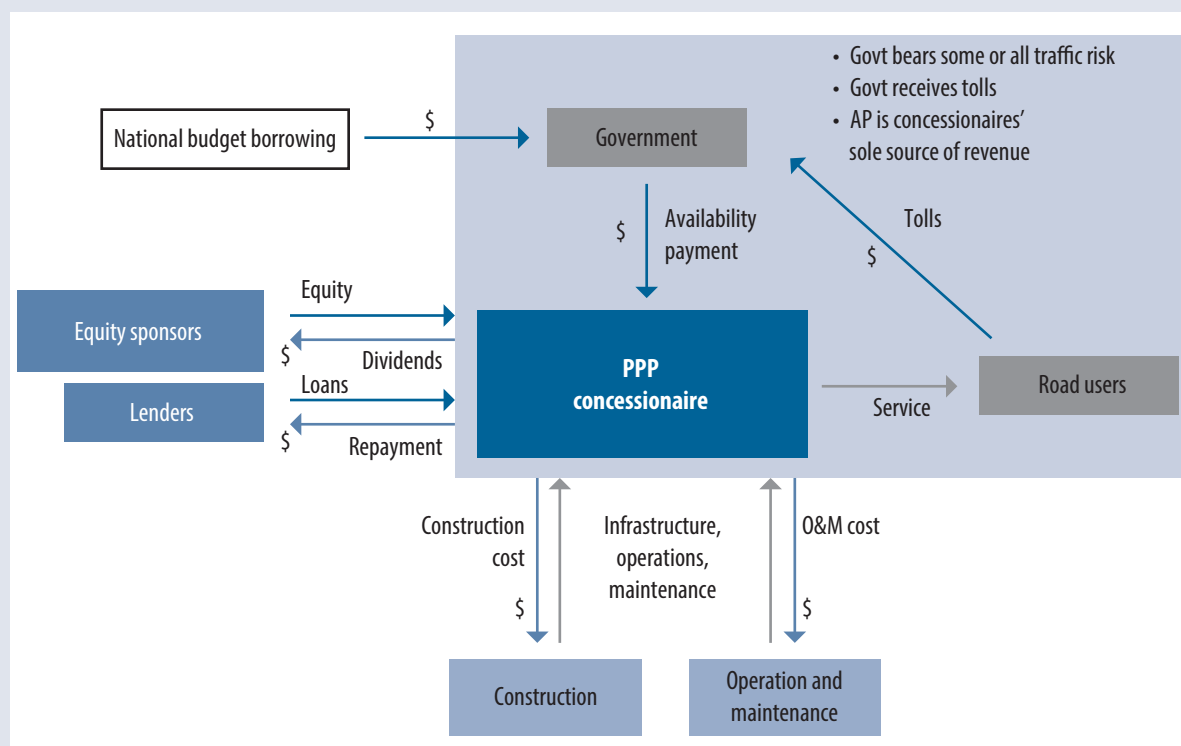
The Government may choose to pay the project company directly for services rendered (or some part thereof). For example, where a road is being developed through PPP, rather than ask the investor to rely wholly on tolls collected, the Government may pay directly to the investor an availability payment (also called an annuity payment in India). The payment is made to the extent the project company provides services to a specific performance standard.

³⁰ World Bank, *Best Practices in Public Private Partnership Financing in Latin America: The role of subsidy mechanisms* (2012).

³¹ *Ibid.*

Box 5.7: Availability Payment Mechanism for Roads

Availability payment mechanisms place downside risk clearly on the Government, but also ensure the Government benefits from the upside benefits (if the road is not used, Government still pays, but if it is very successful, the benefits accrue primarily to the Government). Under a toll based concession, Government reforms can reduce concessionaire revenues, giving the concessionaire the right to claim lost revenues from the Government. The availability payment allows the Government to make changes without concerns of liabilities to concessionaires.



Availability payments provide more certainty of revenues to investors, with the Government as obligor (which may help the project access cheaper debt). While the downside risk is largely absorbed by the Government through this payment stream, the upside potential of high profits from tolls or tariffs will also belong to the Government, potentially reducing the incentives on the private investor to ensure success of the project.

The Government can also pre-purchase, or promise to purchase, a certain amount of output. For example, a fibre-optic network may have a clear advance commitment by the Government to purchase a portion of the network's capacity. Such payments generally reduce demand risk, and provide a guaranteed revenue stream, which in certain cases can be used as collateral for debt.

5.3.3 Loans

The Government may choose to provide access to debt, in particular in local currency, of an appropriate tenor, grace period and terms. However, Government provision of debt may require project assessment skills/capacity that are not typical of the skills found amongst Government personnel.

5.3.4 Equity

Government support in the form of equity is sometimes used to offset equity requirements from private investors, maintain control by the Government over certain project decisions or obtain access to information about the project company that would normally be difficult to achieve. However,

Government equity contributions raise particular challenges for Governments and investors:

- conflict of interest—where the Government is on both sides of the concession agreement, private investors will be concerned that when difficult decisions must be made, Government will be incentivized in a manner different than the commercial priorities of the project.
- decision processes—Government procedures are often a poor fit with good corporate governance, for example voting procedures, appointing board members, and selecting management.
- management and monitoring of Government shareholding—often, Government staff are not familiar with private corporate governance and are unlikely to be able to protect the Government's interests amongst corporate shareholders.

5.4 CONTINGENT SUPPORT

Contingent support only becomes payable (or “crystallizes”) in certain situations. Contingent support can include:

- guarantees, including against breach of contract, non-payment of debt service, adverse movements in exchange rates, lack of convertibility of the local currency or availability of foreign exchange, credit risk of offtake purchaser, tariff collection risk, the level of tariffs permitted, the level of demand for services, payment of termination compensation, etc.
- indemnities, e.g. against failure to pay by state entities or damages associated with undue Government intervention
- stand-by funding (debt, equity or grants), that the project company can draw on, e.g. in the event demand is insufficient, or for cost over-runs.

5.4.1 Government guarantees

Chile has had great success in developing its PPP portfolio. Since 1994, the Government has established a solid institutional framework, well-developed procedures to identify, evaluate and

Key Messages for Policy Makers

- Contingent support can be a powerful instrument, but
 - the risk borne by the Government must be assessed honestly and managed carefully,
 - taking too much risk away from private lenders or enabling reduced equity investment, or over-protecting investors, limits the private investors’ “skin in the game”, so when crisis befalls the project, the investor and lender may be less motivated to help.

Box 5.8: Lessons from London Underground—The Importance of Private Liability

The London Underground project involved three parallel concessions to run different metro lines. Two of these “infracos” could claim additional funds if total cost increases exceeded 50 million pounds sterling (\$80 million), the third if it exceeded 200 million pounds sterling (\$320 million), giving it a powerful incentive to make savings in order to offset any cost increases, rather than seeking additional payments from London Underground. This has encouraged a considerable level of innovation by the third “infraco”.

Source: House of Common, Transport Committee, “The London Underground and the Public–Private Partnership Agreements,” Second Report of Session 2007–08, HC 45 (January 2008).

tender projects and financial markets well-placed to provide financing for PPP projects. But even such a successful program involved extensive Government guarantees and protections for investors in the early days, including guarantees from multi-laterals and credit wraps from monoline insurers.³²

Government guarantees tend to be “partial”, as blanket guarantees are generally less than effective, as they create perverse incentives for the beneficiary not to manage the risk well and should be avoided in most cases.

5.4.2 Contingent debt/equity

Debt and/or equity structures can be created to only draw down or be paid in after certain circumstances have arisen, in a specified timeframe and/or when requested by specified persons. These structures are known as standby, contingent or callable capital. This contingent capital (often subordinated debt) can be used to address challenges that may arise, for example

- construction cost over-runs—e.g. to address underestimates in construction costs due to information provided by the Government, or where certain construction risks are to be borne by the Government

- revenue shortfalls, e.g. where revenues do not meet forecasts, for example during ramp-up, or where traffic does not meet expectations
- exchange rate shifts, requiring revenue support, e.g. to meet debt service obligations.

5.4.3 Contingent contributions

Government grants may also be provided on a contingent basis, once certain construction milestones, financial ratios, investment commitments or other performance criteria have been met. Examples include funding of capital investment only paid out on delivery of outputs or performance e.g. connections for poor households and delivering of services to the vulnerable.

5.4.4 Bilateral / multilateral guarantees

Contingent support mechanisms are also available from development finance institutions (DFIs) and donors, for example the contingent support mechanisms available from the World Bank³³ and MIGA.³⁴

³² IMF, Public Private Partnerships, 2004.

³³ For further discussion, see www.worldbank.org/guarantees and Delmon, Private Sector Investment in Infrastructure: Project finance, PPP projects and Risk (2009).

³⁴ www.miga.org

Box 5.9: Guarantco

GuarantCo is an independent, regionally focused provider of partial credit guarantees. It is a private company owned by the members of PIDG,^a run and managed on a commercial basis. It provides a variety of contingent products including partial credit and partial risk guarantees.

www.guarantco.com

^a The Private Infrastructure Development Group (“PIDG”) which is a multi-donor, member-managed organisation. Current PIDG members include: the UK Department for International Development (“DFID”), the Swiss State Secretariat for Economic Affairs (“SECO”), the Netherlands Ministry of Foreign Affairs (“DGIS”), the Swedish International Development Cooperation Agency (“Sida”), the World Bank and the Austrian Development Agency (“ADA”).

Some private sector providers of capital view bilateral or multi-lateral involvement as improving the likelihood of priority being given to their interests in the event of restructuring by the host Government. This is known in the market as the DFI “umbrella” or “halo”, and is the basis for the popularity of various products, in particular the IFC’s A and B loan program.

5.5 MANAGING GOVERNMENT LIABILITIES

PPP involves important Government liabilities that must be managed carefully to avoid exposing the public accounts to undue risks. While PPP debt is generally off-balance sheet for the Government, it creates important fiscal risks that Government must assess, monitor, report and manage.

5.5.1 Assessing liabilities

The ability to value and assess risk associated with PPP is often created within the debt management function of the ministry of finance, but it might also be tasked to a PPP unit in some other part of Government, for example planning or economic coordination. The assessment of Government liabilities should be assessed at different stages of the project, to confirm what level of liabilities represents value for money for the Government for a given project.

The Government’s objective is to expose liabilities associated with PPP projects to an appropriate level of scrutiny:³⁵

- Creating risk awareness—for example collecting information on PPP contracts and using it to discuss fiscal implications of PPP projects.
- Disclosure of PPP risks—promoting transparency of PPP contracts and the fiscal risks associated with those contracts.
- Risk management—coordinating or even centralizing fiscal risk monitoring and authorization, and providing for auditing mechanisms of the Government’s risk analysis and risk management functions.

5.5.2 Monitoring/accounting for liabilities

The Government will either apply a cash accounting (where liabilities are accounted for once they crystallize) or accrual accounting (where liabilities are accounted once they accrue). Cash accounting will not show the contingent liability unless a contingency fund is created, as discussed below.

Even if accrual accounting is not used, Governments can still use the reporting of such liabilities (creating better transparency) to create the necessary accountability of policymakers and help to manage the relevant contingent liabilities. This has been successfully implemented in a number of countries, for example the Czech Republic and South Africa.³⁶

5.5.3 Paying for liabilities once they crystallize

The Government will need to decide how to fund risk liabilities associated with PPP as they arise. It may simply be able to find space in its budget from time to time for the relevant amount, or may have other sources of funding. Another useful mechanism is an undertaking by a bank or development financial institution that will provide credit to the Government in the event the contingent liability crystallizes.

Several countries have established schemes that reduce Government payment risk, creating a fund able to support guarantee payment obligations as they come due, from accumulated budgetary transfers, fees or taxes collected. Canada, Sweden and the Netherlands have such funds (though not specific to PPP). The expected pay-outs under these contingent liabilities are deducted from the annual budgetary allocation for the relevant line ministries, and are set aside for use in the event the contingent liability crystallizes.³⁷

³⁵ Adapted from Public-Private Partnerships in the New EU Member States: Managing Fiscal Risks, World Bank Working Paper No. 114 (2007).

³⁶ Irwin, Government Guarantees: Allocation and Valuing Risk in Privately Financed Infrastructure Projects (World Bank 2007).

³⁷ *Ibid.*

I have been impressed with the urgency of doing. Knowing is not enough; we must apply. Being willing is not enough; we must do.

—Leonardo da Vinci

Financing for PPP ideally involves long tenor debt, at fixed rates. This allows the high upfront cost of infrastructure to be spread out over its long lifecycle (as much as 30–50 years), and therefore makes the infrastructure more affordable; the fixed rates help avoid sudden changes in financing costs and therefore user tariffs. Long-term financing (12–18 years tenor), either with fixed interest rates or with variable interest rates that are supported by interest rate swaps to become fixed, are generally available in the global currencies, e.g. US Dollar, Euro, Yen and Pound Sterling (with notable exceptions during the credit crunches in 2008/9 and 2011/12), but is more difficult to access in developing financial markets.

Long-term infrastructure investments can provide opportunities to debt capital markets, help to increase the depth and breadth of the markets, establish robust yield curves, and provide long-term placement opportunities in local markets that are often starved of such opportunities. Long-term capital for infrastructure can provide a platform for reforms and market dynamism.

Accessing long term financing for infrastructure in local currency is not so simple. Commercial banks in many countries do not have access to long-term liquidity. They fund themselves primarily through short term deposits. The debt capital markets may offer only short to medium term positions (e.g. 3–5 years), depriving banks of the opportunity to lay off long-term loans against long term bond issuances. These banks will face a “liability mismatch” to the extent they lend long-term (long-term loans funded with (the volatility of) short term deposits).

Governments can do much to mobilize long-term local currency debt. Governments regulate financial markets, setting rules for banking and capital markets, to protect different market actors and encourage

activity in those markets. They also enable and provide market information, clearing functions, rating of credit risk, exchanges for different instruments, etc. One of the key sources of long term local currency financing is institutional investors, such as pension and insurance funds. Government reform programs can do much to protect institutional investors, and thereby enable them to invest in good projects.

While not a focus of this section, it should be highlighted that, in PPP one of the most important efforts a Government can make to mobilize local currency financing is to prepare projects well, ensuring financially viable projects with bankable risk allocation. Government reforms of financial markets can help address these challenges and release the capacity of financial markets to support PPP development.

This section discusses Government efforts to mobilize long-term local currency finance for PPP, in particular through the use of “intermediaries”, such as state owned enterprises (SOEs). Section 6.1 summarizes the sources of long term private capital. Section 6.2 discusses different types of Government intervention to help mobilize long term capital. Section 6.3 analyses the use of intermediaries (e.g. state owned enterprises) to mobilize long-term private capital, and section 6.4 concludes.

6.1 SOURCES OF LONG-TERM, LOCAL CURRENCY FUNDING

This section discusses sources of long-term local capital and how to attract such resources to infrastructure.

Local commercial banks—Local banks (public and private) may provide a very convenient source of

long-term financing. While often less sophisticated than their global brethren, local banks have more access to local currency. Local banks also tend to be less risk averse when assessing projects in their own country, taking a more pragmatic view of Government and political risk, and having the confidence that local bureaucratic and technocratic challenges can be resolved in a satisfactory manner.

Global commercial banks—Global commercial banks are often more sophisticated, with experience in construction risk, operation of infrastructure and structured finance that will give them a clear competitive edge (though this capacity may be located in other offices and not in the local office). Global banks may also have superior access to the global financial markets, with its deep pools of liquidity and long tenors, well suited to infrastructure finance. Global banks may have local activities, giving them access to local currency liquidity, but generally in limited volumes. There are exceptions where the global bank has a strong local subsidiary or branch, but the local offices of global banks may have competing interests and are unlikely to have serious capacity on infrastructure in the local office, as they will be staffed for local operations. For these reasons, global banks tend to focus on foreign currency finance for infrastructure and are less competitive in local currency finance for infrastructure.

Development financial institutions—External development financial institutions (DFIs), including multilateral institutions like the World Bank and the IFC, and bilateral institutions like Agence Francaise de Developpement (AFD) of France, are ideally placed to support infrastructure finance and are increasingly critical to PPP in developing countries. They tend to have relatively low interest rates, long tenors, and grace periods. In addition to debt, they can also provide guarantees and insurance that may address specific financing risks faced by the project. However, DFI financing tends to be in foreign currencies and can involve additional costs, related to the conditions imposed (such as procurement, safeguards, financial management), complying with DFI practices and the time it takes to access finance.

“For a [development bank] not to take enough risk is as bad as it taking too much risk.”

Source: Gutierrez, Rudolph, Homa and Beneit, “Development Banks: Role and mechanisms to increase efficiency” (World Bank Policy Research Working Paper July 2011)

Institutional and retail investors—Long term liquidity may be available in local currency, in particular from institutional investors like pension and insurance funds. Institutional investors like pension funds would seem to offer an ideal opportunity for infrastructure finance. Pension funds hold large volumes of long-term capital; in most countries they have difficulty finding long-term placements outside of Government bonds and real estate. Long term liquidity may also be available from retail investors, such as high wealth individuals otherwise tempted to move capital off-shore, retirees looking for long term security, etc., in particular where other long-term investment opportunities are not available in local currency. Access to these investors is often facilitated through capital markets.

Debt capital markets—Capital markets often hold depth of liquidity in addition to, and often in excess of, that available from commercial banks. Debt capital markets (through the issuance of debt securities often called “bonds”) may provide access to credit at lower interest rates and longer tenors than commercial banks by providing access to retail investors and to institutional investors. However, the financing available through capital markets is often less flexible than the financial instruments available from commercial banks. E.g. they are not designed to provide grace periods (where the lenders agree not to defer payment of debt service during an initial period and instead to capitalise these payments) nor to provide debt in tranches (where the borrower must pay a commitment fee from financial close, but only pays interest once it has drawn down the amount needed), instead under a bond issuance, the project company must borrow the full amount of debt needed at financial close, and pay interest on that full amount until repayment (the extra interest charged for funds not yet needed is called “carry cost”). Also, the most active purchasers of debt securities (i.e. pension funds, insurance and other institutional investors) do not generally have the expert staff and processes of commercial banks, designed to assess and manage risk, and respond to changes and requirements of dynamic investments like infrastructure; and must hire investment banks and other intermediaries to provide such expertise.

Box 6.1: Prudential Rules for Pension Funds

In general, Anglo-Saxon countries adopt the prudent person rule (PPR) in pension fund investment which requires only that funds be invested “prudently” rather than limited according to category. Furthermore, there are few restrictions on investment in specific assets. Such a system in fact requires an efficient court system with well-trained and informed judges, capable of establishing clear jurisprudence on prudent investor behaviour and of guaranteeing its swift enforcement for market participants. In many other countries, different quantitative restrictions have traditionally been applied, normally stipulating upper limits on investment in specific asset classes, including equity.

Source: OECD, Pension fund investment in infrastructure: A survey (September 2011).

Global capital markets—The global capital markets have access to deep and long-term capital, from sophisticated investors likely to be more interested in infrastructure investments. However, these investors are likely to have limited appetite for local currency placements. Even in foreign currency, these investors will be subject to certain limitations on the credit rating of the securities they purchase, in particular the prominence of pension, insurance and other prudential funds in the global markets may limit appetite for anything less than investment grade, or even higher international credit ratings. Global capital markets are unlikely to be a significant source of local currency debt. There have been local currency bonds issued in the global markets (e.g. diaspora bonds), with some success, but usually not in large volumes. These efforts often focus on currencies from countries with large emigrant communities with close contact with their home country and desiring investments in local currency.

Domestic capital markets—Local capital markets have more appetite for local currency positions, and will be less sensitive to political and other country specific risk. However, for the purposes of financing PPP, local debt capital markets often elicit a number of challenges:

- liquidity—local capital markets, in particular in developing countries, often suffer from a lack of liquidity.

Box 6.2: Securitization of Infrastructure Revenues

Dubai hired local and international banks to raise \$800 million by securitizing road toll receipts and will use the proceeds to fund infrastructure projects in the Gulf emirate. Securitization requires a reliable revenue stream; careful structuring from experienced and well respected advisers and possibly credit enhancement to ensure the placement is sufficiently credit worthy to attract debt at the cost and tenor desired.

- tenor—infrastructure is best financed with long term debt. Local capital markets will need a robust yield curve, covering the different tenors up through long tenors.
- familiarity with infrastructure—local investors may not be familiar with the risk profile of infrastructure, and therefore may be particularly risk averse.
- lack of a yield curve—in sum, there are no comparable financial instruments freely traded in the local market, so no way to set a price.

6.2 GOVERNMENT INTERVENTIONS THAT CAN FACILITATE ACCESS TO LONG-TERM LOCAL CAPITAL

A variety of instruments are available where Government seeks to help mobilize long-term local currency financing for infrastructure, including:

- Advisory services bring the assistance of experienced transaction advisers to the aid

of contracting agencies or private investors, depending on the need. Mobilizing debt for infrastructure projects requires particular skills, for example packaging debt efficiently and managing lender groups and their due diligence requirements. One of the key advisory roles is the “arranger” of debt. An arranger needs to know the market and be known by the market to facilitate arranging and negotiation with other lenders.

- Equity and “equity-like” instruments for infrastructure projects can be large in value and risky, with long periods before equity distributions are realized. Sponsors are often the construction companies, infrastructure operators or other service providers whose principal focus is the provision of services to the project. The Government can provide equity investment and supply an intermediary to act as an equity investor. Equity investment in infrastructure is a difficult function to fulfil well; it requires a level of sophistication different than most equity investment. It is not just a question of funding, but rather the governance, the ability to make critical decisions in times of need, and to provide technical and commercial support, given the complexity of an infrastructure transaction.
- Long-term liquidity for equity investors—Equity investors also need access to large amounts of capital. Project sponsors will normally have less robust balance sheets and will not be able to leverage like lenders. In many countries, the lack of equity investment is a major challenge for

Box 6.3: Arguments for Government Equity Holdings in Infrastructure

Some argue that Government should be an equity holder in infrastructure transactions. The argument usually runs that Government needs:

- A share in the upside of very profitable projects, to ensure that Government gets a piece of the action. Counter-argument: But equity distributions in infrastructure are hard to control and harder to forecast. If Government wants to share in the upside, it should require a share of revenues or a fixed lease payment instead.
- Control of the sector—to maintain Government influence over the project and the sector. Counter-argument: But private partners are likely to limit real Government control over the project as equity holders to mitigate conflict of interest and ensure that decisions are made on a commercial rather than political basis. Government would do better maintaining control through regulations and regulatory powers.
- Access to information—Government may see equity as a mechanism for accessing company information. Counter-argument: However, private partners will inevitably establish a governance structure that isolates sensitive information. The Government may find that regulatory powers and data gathering of its own will provide a more practical solution to information access.

infrastructure programs, reducing competition and making projects expensive.

- Debt—The Government may want to, or through an intermediary, help provide or mobilize debt for infrastructure projects themselves. Acting as lender is a difficult function for many Governments who do not have the due diligence, oversight, implementation and other key governance functions of financiers.
- Long-term liquidity for commercial banks—Commercial banks may have staff and capacity to finance projects, but may not have access to sufficient long term local currency capital. Often, their deposit base will be short term in nature, creating a liability mismatch if they create long-term assets. Also, commercial banks may be nervous about using what long-term capital they have on infrastructure (where competing opportunities are more profitable). The Government can help by providing financial institutions (in particular commercial banks) access to long term liquidity which they can then on-lend to infrastructure projects, for example helping commercial banks access local capital markets or supplying/lending long-term funds directly to commercial banks.

6.3 USING AN INTERMEDIARY

The Government may want to provide a vehicle (an “intermediary”) to provide financing for infrastructure projects and an intermediary for institutional investors who could or would not invest directly in projects. Such an intermediary is often created through state owned enterprises, which provide a convenient nexus between public, government support and commercial, private context. Such an intermediary can help:

- use Government and donor funding, to leverage private sector funding
- reduce the transaction costs represented by Government and donor funding by creating a wholesale mechanism
- increase transparency and consistency of Government support by establishing an entity with governance mechanisms and operational guidelines establishing rules of the game

Box 6.4: Chilean Infrastructure Bonds

Chile successfully tapped the bond market for project finance debt through infrastructure bonds amounting to an average of USD 1 billion a year during 1996–2001. This situation was aided by Government revenue guarantees and even foreign exchange guarantees in certain cases and political and regulatory risks were mostly insured by DFIs.

- allow private sector salary scale to attract suitably skilled and expert staff and create a centre of expertise based on larger volumes of transactions, with commercial selection criteria
- use the leverage available through a financial institution to increase the amount of support made available from a limited capital base.

6.3.1 Functionality

Three key functions for the intermediary that can help mobilize local finance include: origination, liquidity and refinancing.

Origination: Intermediaries originating infrastructure finance will assess a project, influence its design and structure, and then build a book of debt either alone, with a club of other lenders, and/or through syndication.

Liquidity: Long tenor funds can be made available to those financiers or as co-financing (senior or subordinated) to the project. Other instruments, like take-out guarantees can be used to extend tenors of debt.

Box 6.5: Tamil Nadu Urban Development Fund (TNUDF)

TNUDF was created as a trust fund with private equity participation and without state guarantees, the first such structure in India. Its paid-in capital combined with debt raised from a World Bank loan allowed TNUDF to issue the first non-guaranteed, unsecured bond issue by a financial intermediary in India, in 2000. The issue received a LAA+ rating from ICRA due to credit enhancement and structured payment mechanism, low gearing and strong repayment record. The proceeds from bonds are deposited in the fund, and subsequently lent back to the participating local bodies as sub-loans to finance their infrastructure projects.

www.tnufdf.com

Refinancing: Liquidity constraints, risk ratios, single borrower limits and other prudential requirements can constrain the amount of support that local financiers can provide to infrastructure markets. Refinancing involves the pre-payment of part or all of a project's debt by borrowing from a new lender (possibly at a lower interest rate, longer tenor or on easier terms).

6.3.2 A few challenges

PPP financial intermediaries (FI) can be particularly difficult to implement effectively. Some of the key challenges when creating an intermediary are discussed below. The annex provides a quick snap shot of some of the global TFs.

Staying demand responsive—the FI must address identified market gaps, with access to products and instruments designed to address those gaps, but also with the flexibility to use other instruments or approaches that respond to the changing nature of such gaps and market needs. The Indonesian Infrastructure Finance Facility (IIFF) was created after much effort at market analysis and coordination with other market actors. The Brazilian Economic Development Bank (BNDES) was a public bank that was adapted to address a growing market need. In the same way, the FI must focus on the gap, rather than squeezing out private investment, it must squeeze-in private lenders and investors, to give them new opportunities. Once FIs are created, it is often difficult to get rid of them once they have served their purpose. Provision needs to be made for the FI to be wound up, sold off, absorbed into another entity or to evolve into some other

mechanism that will be responsive to other market demands, relevant at that time.

Governance and management structures—investment project selection must be based on sound commercial criteria, and not driven by purely political priorities; the risk of capture of the intermediary by political interests is high. This is generally addressed by developing the FI as a privately owned company, for example the IIFF. At the same time, purely commercial motivation may be too risk averse for the investments available. The Emerging Africa Infrastructure Fund (EAIF) faced this challenge, a partnership between development financiers wanting to take risk and commercial financiers with a more risk averse approach to project selection, creating a particular challenge in the early days searching for an appropriate incentive mechanism for the fund manager.

Amount and source of original capital—any effort to make a significant impact on an infrastructure market is likely to require a large investment of capital in the FI. The Indian Infrastructure Finance Corporation Limited (IIFCL) and BNDES were allocated funding from government bond issuances, giving them access to significant amounts of capital at a low cost. The National Infrastructure Fund (FONADIN) of Mexico was allocated the revenues from a portfolio of publicly owned toll roads. The IIFF and EAIF started from a smaller capital base. Other credit enhancement can be provided by the Government.

Skilled staff and resources—newly formed FIs are a risky bet for experienced financiers, and yet an FI needs a solid, experienced management team to

Box 6.6 : Development Bank of Southern Africa (DBSA)

The Development Bank of Southern Africa (DBSA) is a development finance institution wholly owned by the Government of South Africa that focuses on investments and joint ventures/partnerships in public and private sector financing. DBSA can raise money on local and international capital markets and is publicly listed on the New York Stock Exchange. Its bond ratings are the same as South African Sovereign Ratings.

DBSA offers a variety of financial products, including grants, equity, debt (senior and subordinated), underwriting guarantees and other credit enhancement.

Source: <http://www.dbsa.org>.

Box 6.7 : Fondo Nacional de Infraestructura (Fonadin) of Mexico

Fonadin is housed within Banobras, Mexico's national development bank and was created in response to the tight credit market of the financial crisis to address risks that the market was not able to handle. It began with a sum of over 40 billion pesos (US \$3.3 billion) in 2008 and has its own revenue source from existing toll road assets that were rescued in a Government bailout in the late 1990's, and therefore does not rely on Government support for its financing base.

Fonadin's role is to finance infrastructure. It offers a variety of instruments including: grants, subsidies, guarantees (for stock, credit, damage and political risk), subordinated lines of credit, and grants for technical assistance.

www.fonadin.gob.mx

give comfort to the financial market and politicians. They must be able to attract funding from institutional investors and display a keen understating of the infrastructure market. The management team also needs to be committed for a reasonable period, this is not the job for a political appointee, a retiree looking for something to keep them busy, or a short term consultant. The role of CEO is key, a politically acceptable individual but with good banking experience and the right incentives to take calculated risks. The IIFF and the African Finance Corporation both had challenges with their management teams in their early days, finding the right set of skills and personality. These skilled staff can also be sourced through secondments from shareholders as was done for the Infrastructure Development Finance Company (IDFC); or through a management contract as was done for the EAIF.

Identifying a solid pipeline—it is often tempting to focus on the market gap to be resolved by the FI. But, the FI's first investments, the demonstration projects, will be critical and must be carefully prepared as the FI is being created. This creates a timing

challenge as the market is unlikely to wait for the FI. The Investment Promotion and Financing Facility (IPFF) of Bangladesh addressed this challenge by focusing on a series of gas-fired power projects in its first phase, projects that were well developed, easy to market and limited to one sector. Phase two expanded to other sectors and more risky projects. The IDFC and IIFF spent their first few years providing advisory services to the infrastructure sector and thereby developing their own pipelines of investments, the former by necessity and the latter by design.

6.4 CONCLUSION

Infrastructure projects (in particular PPPs) provide an ideal opportunity for holders of long-term local currency. In addition to treasuries and real estate, infrastructure offers one of the better long-term placement opportunities for developing economies. It also creates economic opportunities, jobs, and growth.

However, most developing country financial sectors are ill-equipped to respond to the opportunities of

Box 6.8 : Brazilian Economic Development Bank (BNDES)

Formed in 1952, BNDES raises money through the issuance of Government securities in favour of BNDES. It also has access to the capital markets and can raise money through trading securities and all manner of derivatives; it also earns income from its loan portfolio and can issue debentures. With its long term financing BNDES has been fundamental in the growth of PPP in Brazil. But is also subject to criticism, in particular long wait times for approval of loans, being overly risk averse, and requiring security from sponsors more appropriate to corporate financing than PPP. BNDES is also criticised for squeezing out private lenders due to its dominant position.

Source: www.bndes.gov.br and author).

infrastructure finance. They do not generally have lending products with the long tenors, fixed interest rates and grace periods needed by infrastructure investments. Also, the risk profile for infrastructure differs from the normal diet of local financiers.

Intermediaries can help. These are specially equipped entities that can provide advice, structure projects and offer specialised financial instruments to help address the challenges faced by local financiers. These intermediaries can borrow from the local markets and convert these liabilities into the kind of financial instruments sought by infrastructure projects, and/or they can co-finance with local financial

institutions and financiers to achieve together the lending products sought.

Creating such intermediaries (whether from existing entities or by creating new ventures) can be costly and time consuming. There is no easy or standard approach to intermediation. Each country will need to consider carefully its requirements, its legal framework, the make-up of its financial sector and the kind of infrastructure that is to be financed, before creating such an intermediary. Key lessons have been discussed above, learned from countries that have significant experience in creating intermediaries for infrastructure finance.

Annex 1

The following provides a snap-shot of a few of the global Financing Intermediaries.

Investment Promotion and Financing Facility (IPFF) of Bangladesh is a publicly held vehicle in operation since 2006 that provides long term funding through eligible financial institutions, who on-lend to qualifying PPP projects on market terms. The equity contribution of the sponsor (minimum of 30%) and the debt share of the local financial institution (minimum of 20%) ensure market-based incentives in selecting only commercially viable PPP transactions, and their successful implementation.

FONADIN (National Infrastructure Fund – Mexico) was established in February 2008, under the management of the national infrastructure bank Banobras. Fonadin was created in response to the tight credit market of the financial crisis to address risks that the market was not able to handle. It began with a sum of over 40 billion pesos (US \$3.3 billion) in 2008 which will build up to approximately 270 billion pesos (US \$22.2 billion) in 2012 through toll-road revenues. Fonadin can offer credit guarantees to project companies seeking funding from commercial banks or financial intermediaries or for bonds issued by a concessionaire. Fonadin can cover up to 50% of the loan or issuance with its guarantee. Fondo Nacional de Infraestructura (Fonadin) of Mexico Fonadin's role is to finance infrastructure. It offers a variety of instruments including: grants, subsidies, guarantees (for stock, credit, damage and political risk), subordinated lines of credit, and grants for technical assistance.

www.fonadin.gob.mx

Infrastructure Development Finance Company (“IDFC”) of India was set up in 1997 by the Government of India along with various Indian banks, financial institutions and IFIs. IDFC's task is to connect projects and financial institutions to financial markets and by so doing develop and nurture the creation of a long-term debt market. It offers loans, equity/quasi equity, advisory, asset management and syndication services

www.idfc.com

India Infrastructure Finance Company Limited (IIFCL) started operations in April 2006. IIFCL accesses capital from the Government, IFIs and the financial markets (in some cases benefitting from a Government guarantee). These funds are on-lent to PPP projects. The IIFCL does not have a sophisticated risk assessment function. It follows commercial banks, providing only part of the debt requirements of the project and therefore ensuring that the incentive to assess projects and ensure successful implementation rests squarely on the commercial equity and debt providers.

Indonesian Infrastructure Finance Facility (IIFF) is a private, non-bank financial institution, commercially oriented with private sector governance, mandated and equipped to mobilize local currency private financing. The IIFF is capitalized through equity investments and subordinated loans from the Government, the private sector and multilaterals. It will invest in PPP projects, with debt, equity and/or guarantees, and by providing advisory services. (Infrastructure Development Finance Company (IDFC))

Emerging Africa Infrastructure Fund (EAIF) is a US\$600 million debt fund, which aims to address the lack of available long-term foreign currency debt finance for infrastructure projects in sub-Saharan Africa. The EAIF was created through a joint venture of development institutions and commercial banks. By mixing equity from donors, subordinated debt from development partners with senior debt from commercial lenders, EAIF seeks to reduce its cost of lending and provide mid-market debt managed by commercial lenders.

Indonesian Infrastructure Guarantee Fund (IIGF) is a company, wholly owned by the Indonesian Government, that acts as the single window for guarantees for PPP projects. It assists the MoF in its role of monitoring and allocating Government support by assessing projects and helping to source any guarantees needed for that project, for example from the World Bank, MIGA, its own capital or the Government.

Brazilian Economic Development Bank (BNDES) is a publicly owned commercial bank. Formed in 1952, BNDES raises money through the issuance of Government securities in favour of BNDES. It also has access to the capital markets and can raise money through

trading securities and all manner of derivatives; it also earns income from its loan portfolio and can issue debentures. With its long term financing BNDES has been fundamental in the growth of PPP in Brazil. It is a dominant force in Brazil's infrastructure market and provides debt for most of its PPP projects. As a Government owned Bank it received funds from the Government and uses the Government's credit position to offer very low rates for long-term debt. BNDES is also subject to criticism, in particular for squeezing out private lenders due to its dominant position, for long wait times for approval of loans, being overly risk averse, and requiring security from sponsors more appropriate to corporate financing than PPP.

www.bndes.gov.br

Development Bank of Southern Africa (DBSA) is a development finance institution wholly owned by the Government of South Africa that focuses on investments and joint ventures/partnerships in public and private sector financing. DBSA can raise money on local and international capital markets and is publicly listed on the New York Stock Exchange. Its bond ratings are the same as South African Sovereign Ratings. DBSA offers a variety of financial products, including grants, equity, debt (senior and subordinated), underwriting guarantees and other credit enhancement.

www.dbsa.org

Tamil Nadu Urban Development Fund (TNUDF) was created as a trust fund with private equity participation and without state guarantees, the first such structure in India. Its paid-in capital combined with debt raised from a World Bank loan to the Government allowed TNUDF to issue the first non-guaranteed, unsecured bond issue by a financial intermediary in India, in 2000, three to four years after being established. The issue received a LAA+ rating from ICRA due to credit enhancement and structured payment mechanism, low gearing and strong repayment record. The proceeds from bonds are deposited in the fund, and subsequently lent back to the participating local bodies as sub-loans to finance their infrastructure projects.

www.tnudf.com

Annex 2

Aggregate Key Messages for Decision Makers:

- *Learning by doing*—an important part of identifying gaps in the investment climate is learned while “doing”, while implementing PPP projects.
- *Use small steps without being timid*—start with easier projects that are clearly financially viable and have political support. But these projects need to provide a signalling effect; they need to be sufficiently substantial and strategic to ensure Government buy-in, the interests of private investors and a statement to the market that the framework for PPP in the country is conducive.
- *Learn from the experiences of others, without being dogmatic*—there is a tendency to try to replicate the successes of other countries. While it is important to learn from the successes and failures of others, it is generally unwise to try to replicate an entire framework, wholesale.
- *Keep it simple*—complex is not necessarily comprehensive or better, the PPP framework needs to be understood by a wide group of stakeholders.
- *PPP policies should be clear, comprehensive, yet flexible*—periodic updates are a useful way to adopt lessons learned into the PPP program.
- *Keep the legal framework simple and clear*. Do not confuse complexity with comprehensiveness. Simple is better, and will give more confidence to investors. Detail is best left to secondary legislation that is more easily amended to respond to change.
- *Do not use the legal framework to second guess the PPP contract by creating rights and obligations at law that should be addressed in the contract on agreed terms*. If the Government is keen to establish such terms, standard form documents can achieve this, where the terms can be spelled out in detail.
- *Make sure the different roles are allocated and that the system works*, ideological purity is less important.
- *Institutions are only as good as the people in them*, and the funding/mandate they are given. Real capacity building (not just the occasional training or trip abroad) is key to a sustainable programme.

- *Strong, consistent leadership is key*—coordination amongst different institutions and ensuring consistency of practices and focus of efforts generally requires clear direction from the highest levels of Government.
- *A robust value for money assessment and transparent, competitive procurement* can protect the Government and the project from ex-post criticism, and can make the project less vulnerable to change, external shocks and the temptation of future Governments to reverse decisions.
- *Do not cut corners in procurement.* It may seem easier to enter into direct negotiations instead of using competitive procurement, but it isn't. It takes longer and costs more money. Maximize competition (where possible) through good, transparent, competitive procurement.
- *Invest in preparation.* PPP preparation takes time and money, if done well.
- *Be clear to bidders about what you want.* Indicate clearly what results, milestones and indicators you want the investor to achieve, in particular in the bid evaluation criteria and their weighting. Help bidders to give you what you want, don't make them guess.
- *Be cautious when selecting the winning bid.* If a bid seems too good to be true (financially, technically or otherwise), then it probably is.
- *Select good projects.* Garbage-in-garbage-out; say "no" to bad projects
 - Select robust, viable projects for PPP, these are more likely to be financed on a competitive basis and are therefore more likely to provide value for money. Projects suffering from bad design, dubious demand or weak fundamentals (even if politically popular) are more likely to fail, and may weaken the entire PPP program in the process.
 - If a project needs Government support, get approvals early to avoid wasting time and money on projects that do not meet viability and value for money criteria, and the awkward position of Government rejecting support for a project only after much effort is spent on its preparation.
- A good, transparent selection process (for commercial rather than political reasons) can reassure investors and increase competition. Projects selected for political reasons or priorities will create a perception of increased political risk amongst investors.
- *Prepare the Government to play its part from project development to expiry.* Even where a comprehensive PPP is envisaged, the Government will play an essential role in monitoring and regulating the project and the sector.
- *Be ready for challenges.* In any long-term relationship, change happens. PPP is, above all, a partnership, and it needs to be designed with challenges, changes and resolution in mind. Problems need to be elevated to appropriate levels of management before they become disputes or worse.
- *Consider all stakeholders.* PPP will have a direct influence on some stakeholders (in particular employees and management) and may raise political or philosophical concerns amongst many more. While absolute consensus will never be reached, the Government needs to consult widely, understand fundamental concerns and address them.
- *Be proactive.* Establish mechanisms intended to catch disputes as early as possible. Early in the process, options are varied, relative cost is low, and the likelihood of immediate value-added resolution is higher.
- *Facilitation can help.* Softer processes are designed to use and develop relationships as the basis for finding mutually satisfactory solutions and can work better than more formal processes.
- *Renegotiation can be an opportunity,* and can improve the PPP arrangements and protect the poor, if it is contemplated in advance, transparent and well managed when needed.
- *Get good advice.* Do not try to manage disputes or renegotiations with internal staff alone, no matter how good they are. Get the best, external advice. It will cost money, but will save money in the long run.
- *Government support* can improve financial viability and make a project more attractive

for investors, but it *will not turn a bad project into a good one*.

- *Use Government support efficiently*, in a targeted manner, to ensure Government goals are achieved.
 - Ensure funding mechanisms are properly resourced and incentivized to *avoid political capture or inertia*.
 - *Avoid perverse incentives* created by Government support—ensure private and public are motivated to make the project a success.
- *Contingent support can be a powerful instrument, but*
 - The risk borne by the Government must be assessed honestly and managed carefully,
 - Taking too much risk away from private lenders or enabling reduced equity investment, or over-protecting investors, limits the private investors' "skin in the game", so when crisis befalls the project, the investor and lender may be less motivated to help.



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