8

Key lessons learned and emerging best practices on PPPs

The experience of PPPs in Commonwealth countries shows that successful projects can deliver significant benefits in terms of increased quantity and quality of infrastructure services. Moreover this can be achieved at lower overall cost for customers and taxpayers if suitable incentives are in place for the private partner to deliver efficiency improvements. On the other hand, when PPPs fail, the costs can be high, resulting in protracted and expensive legal disputes and the loss of political support for private sector involvement in infrastructure. Failures can also imply loss of government funding and consequently a decline in spending on other much-needed infrastructure services. In the worst cases, customers may suffer through service disruptions or unaffordable increases in tariffs.

Listing the factors attributable to successful PPPs is relatively straightforward (see Box 8.1). But these are not sufficient conditions. Every project will raise a different set of issues that must be dealt with by capable and experienced individuals from both the public and private sectors. Challenges are likely to arise throughout the project life cycle, from the project development phase through construction and operation (i.e. well beyond contract signing). Many of the key lessons on PPPs are therefore related to the need to take a long-term view when designing and implementing a PPP programme.

Box 8.1. Success factors for PPPs

- Strong political will
- Underlying economics of the project are attractive
- The project is well-designed and structured
- Capable private sector sponsor
- Access to suitable sources of finance/guarantees
- Robust legal and institutional framework for PPPs
- Strong public sector capacity

The experience of PPPs in developing countries (for example in the specific case studies presented in Annex 5) raises three main sets of lessons, discussed below.

Lesson 1: *PPPs should be designed with long-term sustainability and value for money considerations in mind.*

It is widely recognised that many countries, including OECD markets, are attracted to PPP solutions because they offer access to private capital. Raising funds on capital markets can help governments avoid short-term budgetary constraints by spreading the up-front costs of infrastructure investment over the lifetime of the project. In emerging markets, where fiscal capacity is often seriously limited, PPPs can help governments tackle the infrastructure gap and provide services to those not previously reached by the public sector.

But it would be a mistake to view PPPs as only, or mainly, about raising capital. The success of a PPP programme should be assessed against the quantity, quality and cost of infrastructure services provided to the public over the long term. There is a danger that an approach to PPPs focused on the raising of capital will fail to properly assess or allocate the underlying risks in a project, with the result that the government may not end up getting value for money. In the worst cases, this may lead to the failure of the project, causing service disruptions and potentially high costs for government.

Key to ensuring long-run sustainability and value for money of PPPs are the following:

- Robust feasibility analysis;
- Proper due diligence in selecting a strong private sector sponsor;
- Good project and contract design.

Robust feasibility analysis is essential

In the early years of modern PPP programmes in Europe and North America, a common mistake was for government and project sponsors to overestimate future revenues on PPP contracts. This was especially the case for toll road concessions, where traffic forecasts were over-optimistic – for example, more than half the Mexican toll roads reached less than 50 per cent of the forecasted volumes and the M1/M15 toll road in Hungary achieved less than 60 per cent of projected traffic flows in its initial years of operation.[1] Many contracts ran into difficulties, with the sponsor being unable to fund maintenance programmes because of lower than expected traffic volumes.

Nowadays there is more awareness of the importance of robust feasibility analysis which incorporates various scenarios about key revenue and cost drivers. But there are still examples of projects that fail because bidders were over-optimistic about future performance (for example the East Coast rail concession in the UK in 2009 – see Box 3.3).

In emerging markets there is often the additional challenge of a lack of data to inform a feasibility analysis. For example, reliable information on the number of potential customers for a service and the level of tariffs they are willing and able to pay is typically unavailable. This implies there will often be a need to spend relatively more time and effort at the feasibility stage in emerging markets to ensure that a proper case can be made for structuring a project as a PPP.

Proper due diligence is required when selecting a private sector sponsor

A common mistake when selecting a private partner is to focus on a limited number of variables (e.g. lowest cost tariff) without making a wider assessment of the capability of the sponsor to deal with unexpected events as they arise and implement the PPP contract successfully over the long term. This was arguably one of the main failings of the Kenya-Uganda rail concession and even of the Tanzania City Water transaction.

Of course, attracting the right sponsor and getting the best deal for the public sector is linked to the fundamental attractiveness of the project and how effectively it is marketed. In some situations it may not be possible to attract more than one competent bidder, in which case the government should undertake careful due diligence to determine whether or not the contract will deliver value for money. South Africa is an example where VfM considerations are built into the PPP legislative framework (see Box 8.2).

Box 8.2. South Africa Treasury Regulation 16 – Public–private Partnerships, issued in terms of the Public Finance Management Act, 1999

(Gazette No. 25915, 16 January 2004)

Contracting PPP agreements – Treasury Approval: III

After the procurement procedure has been concluded but before the accounting officer or accounting authority of an institution concludes a PPP agreement, that accounting officer or accounting authority must obtain approval from the relevant treasury –

(a) that the PPP agreement meets the requirements of affordability, value for money and substantial technical, operational and financial risk transfer as approved in terms of regulation 16.4.2 or as revised in terms of regulation 16.4.4;

(b) for a management plan that explains the capacity of the institution, and its proposed mechanisms and procedures, to effectively implement, manage, enforce, monitor and report on the PPP; and

(c) that a satisfactory due diligence including a legal due diligence has been completed in respect of the accounting officer's or accounting authority and the proposed private party in relation to matters of their respective competence and capacity to enter into the PPP agreement.

Source: http://www.ppp.gov.za/Documents/ppp_legis/Reg16_January2004.pdf

A PPP approach may not be the optimal solution if sustainability and value for money cannot be assured

Risk allocation, incentives and affordability are the three key aspects for the 'bankability' of a project; their consideration in the project structure will distinguish a 'good' from a 'bad' project. Projects need to be 'bankable' to attract private sector interest. Related to good project design is that it is interpreted clearly in the contract. Good contract design warrants that: (i) the processes and procedures for the PPP are clearly spelt out; and (ii) the measures for evaluating the performance of the PPP are clearly laid out.

Given the above, it is important to recognise that at times the PPP approach may not be the best one to follow. There will some projects where a PPP approach is not considered suitable, even though a private sponsor may want to invest, because long-term sustainability or value for money cannot be assured with sufficient certainty. The City Water project (Tanzania) is an example where the underlying economics of the project were unproven from the start (weak feasibility analysis based on poor data) and the private sponsor allegedly lacked suitable experience in operating this type of concession (poor due diligence on sponsor). With hindsight it might have been preferable for the government to have delayed awarding a contract to the private sector until more data had been gathered about the willingness of customers to pay user fees for improved services. This would also have allowed more time for the development of a PPP legal and regulatory framework, which could have encouraged additional bidders for the concession.

Lesson 2: *PPPs should be viewed as long-term commercial relationships between the public and private sectors, and not one-off procurement exercises or sales transactions.*

A related lesson is that the role of government in a PPP remains important over the full life cycle of the project. This is a major difference to traditional outsourcing arrangements where the public sector typically runs a one-off procurement exercise and then steps back to allow the private contractor to implement the contract. It also distinguishes true PPPs (see Section 3) from privatisations or divestitures, where, again, the public sector's role is limited to a regulatory role after the introduction of the private sector.

The long-term nature of PPPs has implications for the PPP framework, ongoing management of the contract and the skills and experience needed in the public sector.

Establish a flexible PPP framework

Although the lack of a PPP framework does not prevent PPPs from going ahead, it does reduce their chances of long-term success. The main reason is that without a suitable framework the PPP contract for a specific project must attempt to capture all eventualities that may arise over the lifetime of the project. Since PPPs typically have a life cycle of at least 15 years beyond financial close, this is almost impossible to achieve. Under a strict contractual approach there is a risk of a rapid descent into arbitration if events occur which materially impact on the performance of the contract. This issue has been discussed at length in Section 4.1, as well as highlighted as an important constraint to infrastructure PPPs in Section 5.1.

The best way of avoiding this situation is to have a PPP framework that establishes broad principles for ongoing dialogue and co-operation between the public and private sectors beyond contract signature. The framework should include a process for renegotiation where unexpected events occur which are beyond the control of either party – for example, as highlighted by the EBRD in the core principles for a modern

concession law in Box 4.2 above. In situations where the PPP framework is absent or underdeveloped, flexibility should be designed into the contract itself.

Ensure effective ongoing management of the PPP contract

As mentioned above, the role of the government in a PPP is important over the full life of the project. Post-financial close, efficient contract management and monitoring are key to the success of the project. The government needs to manage the PPP contract in such a way that it delivers the desired outcomes for the public sector and value for money. Central to this is the monitoring of the performance of the PPP (one of the key risks usually transferred to the private sector in a PPP). A good monitoring system (also built into the contract) is important to keep track of deviations, if any, and consequently forms the base for public action, as may be required.

The suitable institutional framework for monitoring of PPP contracts depends upon the complexity and number of transactions. As highlighted in Box 4.9 above, there can be a number of different options, but the key lesson is that the institutional framework should be 'fit for purpose'.

The public sector needs staff with appropriate business skills and experience

'People matter' – evidence from the World Bank shows that a successful partnership between the public and private sectors depends to a large extent on the people involved in the project.[2] Naturally it is important that both parties have the right skills and experience to execute the PPP project development process successfully. In particular, public sector employees involved in negotiating and managing PPPs benefit from having commercial, i.e. business, experience or training. (There is, of course, still a need for specialist legal, technical and financial skills which can be accessed through long-term secondments of external experts and through contracting professional advisers for specific projects.) Where there is weak public sector capacity, the potential for a suitably designed PPP unit can offer much advantage.

It also matters that there is regular and effective communication between the public and private sectors: this will be easier if both parties share a commercial approach to the partnership rather than a legalistic one.

Lesson 3: *PPPs are inherently complex, costly and time-consuming to develop properly. A rushed project often becomes a failed project.*

A third set of lessons arises from the fact that PPPs are almost always complex transactions. As set out in Section 4.2, the project development phase alone typically lasts three years (often longer for greenfield projects) before finance is secured and ground-breaking can commence. This timetable sits uncomfortably with short-term political horizons. There can be a temptation for governments to short circuit the project development process in order to deliver on public expectations of improved services from a PPP programme. A high level of political support, as well as suitable management of

political and public expectations on PPPs, is crucial to their success. In addition, given the complexity of PPPs, expert advice is very important.

High-level political support is essential

This is essential for the success of a PPP, especially during the project development stage when there is potential for significant delays if there is not a champion within the government who can drive through required legislation, and licence and land allocation agreements. A strong PPP unit can play an important role in pushing PPP projects up the political agenda, but there may still be occasions when high-level political support (say from ministers) may be necessary. Strong government commitment to PPPs is essential to secure private sector confidence.

It is important to manage political expectations about the time it takes to design and execute a PPP project properly

In particular, it is important to avoid 'over-selling' PPP projects early in the project life cycle because of the risk of creating unrealistic expectations of what can be delivered and by when. Ministers will need to be persuaded to support greenfield projects, despite the fact that operations are unlikely to commence within one or two electoral cycles.

One way of building public support for a PPP programme is to focus on a small number of 'easy wins' for the initial round of projects (e.g. in the power or transport sectors rather than in water and sanitation). This is also likely to have benefits in terms of building capacity and experience within the public sector about how to develop PPPs. As experience in India has shown, the demonstration effect of successful PPPs can be very powerful in encouraging government and the private sector to support other transactions.

Expert advice is expensive but necessary

Legal, technical and financial advisers for PPP projects can be expensive, reflecting the fact that professionals with international experience of working on PPPs are in scarce supply. Advisory fees will typically account for between 5 and 10 per cent of the total project cost. However, assuming professional services are competitively procured, this investment is essential to ensure the project is properly designed and structured. It is especially important that the public sector has access to high-quality advisers to make sure there is an equitable sharing of costs and risks with the private sector.

Box 8.3 presents India's approach to the empanelment of transactions advisers for PPP projects. In addition, Section 6 and Annex 4 describe some of the international facilities that are available to governments to pay for technical assistance.

Box 8.3. Empanelment of transaction advisers for PPPs in India[3]

The Government of India has adopted a policy to facilitate private investment in infrastructure and recognises the importance of appropriate advisory support for the implementation of PPP transactions. Accordingly, the government has finalised a panel of pre-qualified transaction advisers to assist public sector agencies in PPP transactions.

The purpose of the panel is to:

- Streamline the tendering process for the engagement of transaction advisers for PPPs;
- Enable fast access to firms that have pre-qualified against relevant criteria; and
- Ensure transparency and accountability through clear definition of the processes and the role and responsibilities of the agencies and the private sector.

The evaluation for empanelment of transaction advisers has been undertaken on the basis of two-stage evaluation criteria, which requires each agency to satisfy minimum threshold requirements of annual turnover and human resource capability. Applicants who have satisfied the threshold requirement have been evaluated for their capability and experience in discharging a lead role in transactions and providing commercial, financial and legislative advice.

The panel is available to all sponsoring authorities, including central, state and municipal governments and their agencies in India who are undertaking PPP transactions.

Notes

1. Harris (2003), op. cit.
2. World Bank, *Does Private Sector Participation Improve Performance in Electricity and Water Distribution?* (2009).
3. http://www.pppinindia.com/pdf/User_Guide_for_Tr_Ads_final_approved.pdf